Are stock prices determined by facts or human nature?

By John Waggoner, USA TODAY

Wall Street has long liked to portray the markets as fiercely efficient, an instantaneous and dispassionate mechanism for valuing companies, commodities and even loans.

By Sam Ward, USA TODAY

And, in academic circles, there's a name for that notion. The Efficient Market Hypothesis holds that a stock's price reflects all current available information and is, therefore, always fully and rationally valued. And that means you can't beat the market over the long term: Active management is a mug's game. You could do just as well as a money manager by throwing darts at your newspaper's stock listings.

But the past decade has taught us that markets can be anything but rational. So today, behaviorists rule: They tell you that investors hold losing stocks not so much because they're undervalued but because it's hard to admit defeat. They note that men tend to trade more aggressively than women because, well, they're men. And most people buy stocks because they're going up — not because of earnings prospects.

Which is right? Both camps have good points. Efficient-market theorists brought us index funds, which are excellent investments — not because they beat the market, but because they keep fees and taxes low. And behaviorists tell us how we can overcome our own worst

Rational ...

Study after study has shown that it's exceptionally difficult for a manager to outperform a broad-based stock index, such as the Standard & Poor's 500-stock index, over an extended period. For example, 63% of large-company blend funds have lagged behind the Vanguard 500 stock fund the past 15 years, according to Morningstar, which tracks the funds. (Large blend funds, which look for shares of large companies selling at a reasonable price relative to earnings, are the most similar to the Standard & Poor's 500-stock index.)

Managers fared even worse in some categories. Standard & Poor's found that 82% of all midcap core funds failed to beat their index, as did 60% of small-cap core funds.

Furthermore, those few managers with hot hands often don't last, a phenomenon called reversion to the mean. Essentially, it means that a fabulous track record typically fades and becomes an average one. Case in point: Bill Miller, manager of Legg Mason Value Trust, beat the S&P 500 for 15 consecutive years from 1991 through 2005, one of the most impressive streaks in money management. Very few managers have a long-term record that comes close to Miller's. Nevertheless, the market caught up with him during the 2007-2009 bear market, when the fund lost 72%. His current 10-year record lags behind the S&P 500.

And for every Bill Miller, there's a Charles Steadman, who ran the snakebit Steadman Technology & Growth fund, which managed to lose nearly 90% over 30 years. Those 30 years, incidentally, ended in 1997, one of the best periods ever for stocks.

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Because it's so hard to beat an index, efficient-market adherents say it's best to stick with a fund that tracks an index. You won't get top-flight performance, but you won't get rotten performance — relative to the index, that is. Investors in the Vanguard 500 fund did indeed beat the average fund the past 10 years, but they also earned an average of 2.2% a year, less than they would have by investing in ultrasafe three-month Treasury bills.

Or not?

No matter what the efficient-market theory says, the past decade has shown that markets are capable of being remarkably stupid. Intel, for example, was probably not worth $146 a share in July 2000, during the dot-com bubble, nor was it worth only $13.22 in October 2002 at the bottom of the tech wreck. And even though you have a really great yard, your house probably wasn't worth a million dollars in the summer of 2006.

Behaviorists, who argue that the market is moved as much by human nature as it is by fundamental information, say the big problem with the Efficient Market Hypothesis is that people aren't always rational. "The problem with economics is that psychology isn't in our department," says Robert Shiller, Arthur M. Okun professor of economics at Yale University.

Bubbles and crashes are proof of that, says Jeremy Siegel, author of *Stocks for the Long Run*. "The case was weakened significantly by such extreme price movements," Siegel says. It's hard to believe that the 1,000-point swing in the Dow Jones industrial average on May 6 was the result of a rational market.

"Markets are extremely efficient," says Steve Wood, strategist for Russell Investments. "But they're not always right. They can very efficiently price in inaccurate information." Adds Shiller, "The economic crisis was caused by bubbles in various markets, which are not driven by the rational side of human thought."

And, Wood says, some markets aren't efficient. For example, consider the market for bonds issued by companies in emerging markets. Relatively few analysts cover the emerging-market bond market, and an analyst who does work diligently can get better information than others — in other words, he can take advantage of market inefficiencies.

Other studies arguing against an efficient market show that investors tend toward overconfidence. Just as most people consider themselves above-average drivers, most people also consider themselves to be above-average investors. Overconfident traders tend to trade often, which raises their trading costs and reduces their returns, according to a 1998 study in *The Journal of Finance.* A later study, looking at trading records for all of Taiwan, found that individual investor losses amounted to 2.2% of GDP, almost as much as the Taiwanese spend on clothing and footwear. Most of those losses came from overly aggressive trading.

When people aren't rational, savvy investors can scoop up bargains or sell stocks that have soared too far, too fast. And, while academic research has had a hard time documenting good investment strategies, that doesn't mean they don't exist. "There are people making money in the markets through skill," says Terrance Odean, professor of finance at the Haas School of Business at the University of California-Berkeley. "They're just not writing papers about it."

Take pages from both

Behaviorists and efficient-market theorists aren't going to agree any time soon. But they have come to a sort of uneasy truce. Efficient-market theorists will generally admit that individual investors often trade erratically and, therefore, at least one section of the market can't be considered efficient. And behaviorists concede that it's hard to tell when people are behaving rationally, even at the height of a bubble. "There's probably not a historical bubble in which an intelligent investor didn't buy near the top," Odean says.

What can investors learn from both camps?

•Index funds really are a good way to invest for most people. If most managers can't beat the index, you may as well buy the index. Be wary of new funds that follow obscure or narrow indexes, or use leverage, says Don Phillips, principal at Morningstar. "I think more charlatans operate on the index side than the actively managed side." And avoid the temptation to day trade exchange traded index funds.

•Keep costs low. The biggest advantage to index funds isn't performance; it's that they can keep costs low. A $10,000 investment in Fidelity's Spartan 500 Index fund will cost you $10 a year in fees. Investing in a more expensive fund makes little sense. The Rydex S&P 500 C shares, for example, charge 2.28% a year in expenses, or $228, far more than the average actively managed fund. You'd be far better off in a fund with minimal expenses, such as the Fidelity Spartan 500 Index fund, the Vanguard 500 Index fund, or the SPDR S&P 500 exchange traded fund, all of which charge 0.10% or less.

•Be humble. We all would like to think that we're great investors. But in reality, you're competing against people who invest for a living and have vastly more information and resources than you do. Investing is hard work, and just because you're a good doctor or lawyer doesn't mean that you can beat the pros in your spare time, Odean says.

•Don't buy stocks because they're in the news. Stocks hyped on TV or elsewhere often have a small move up as people jump on. But your odds of getting the next Google from CNBC's Jim Cramer are fairly long.

•Admit when you're wrong. Most people hesitate to sell losing stocks because it hurts to admit that they made a mistake. "It's less painful to postpone the decision," Odean says. But selling your losing stocks or funds, particularly in a taxable account, can be a smart move: You can use your losses to reduce taxable gains and income.

But the biggest lesson you can learn from both camps is this: Predicting the market is hard, uncertain work. Most people don't do it well. Don't bet your retirement on getting red-hot returns. You can control how much you invest, which is the single largest determinant of how much you'll have when you retire. And you can control your taxes and expenses. But you can't know what the stock market will give you.

"You have zero control over that," Odean says.

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ALL-CAPS
11:06 PM on February 14, 2011
Score: 10

Are stock prices determined by facts or human nature?

____

If by human nature you mean GREED, STUPIDITY and FEAR then human nature for sure!

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cowshed
11:55 PM on February 14, 2011
Score: 7

The author left out one key learning, which I think is even more important than any of the ones he listed: over the long haul broad stock index funds (preferably more than one, to spread your risks even more), will do as well as the market, which has averaged around 10%, including re-invested dividends, over the past century, so don't panic if the market goes down.

I've tracked my own 403b savings plan, invested in a variety of stock index funds as well as a small percentage in bond index funds over the past 10 years, including the last two recessions, and so far I'm averaging well over 10% average annual return, even after management costs, which are, as the author notes, very small for this type of investment.

The only regret I have is that during the first recession of the decade I shifted a significant portion of my investments into the bond index funds and missed out on significant earnings before I could react when the market bounced back. I left my investment allocations without change during the most recent recession, and benefitted much more by the market bounce-back than I would have by trying to time the market.

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Just one person's experience, but if anyone else can benefit from it, great.

Alex19446
7:04 AM on February 15, 2011
Score: -3

The stock market seems to be run by idiots. A company announces a profit and it's stock goes down. A company announces a loss and it's stock price goes up. Analysts go on TV and explain stock prices change because of vague things like the Federal Reserve said the Fed can not rule out inflation five years from now.

2 replies

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zman072707
8:00 AM on February 15, 2011
Score: 3

A slim margin of facts but a metric ton of emotions!

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YoSaMaObama
8:05 AM on February 15, 2011
Score: 1

Stock buying is purely psychological. Why would someone buy stock in a company if it was loosing money and ready to go bankrupt? GM is an example. Then they bought stock in the new restructured out of bankruptcy. Stock buying/selling is a perception of a company's value going down in price or going up. Oh there are the poop sheets and charts that tell the technical and fundamental trader where the company is at but they don't guarantee where the company will be actually. Mostly people react on news.

1 reply

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lkjhgf
8:37 AM on February 15, 2011
Score: 5

A recent paper by Dr. James Cheung concludes the stock market exhibits the clinical symptoms of bipolar disorder and is, in fact, manic-depressive. The treatment is a stable official interest rate policy that raises rates when the patient is overheated and lowers rates when the patient is sluggish. Side effects include periods of economic impotency and politicians attempting to lessen the dosage when manic periods coincide with election years.

1 reply

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NIKKG
8:53 AM on February 15, 2011
Score: 1

The stock market is all run by snake-oil salesmen. The whole system is manipulated by the rich elite to fool the common man. Its better to go to the casino and play blackjack, at least then you'll have a better odds.

1 reply

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iceload
9:03 AM on February 15, 2011
Score: 3

Everybody knows this is nothing but placing a bet and in time the house always wins. And thats why when everyone got pushed out of retirement plans so "money managers" (a laughable title) can place bets for them. In time the majority lost big. The only winners were the insiders and scammers. And after destroying the economy, we still have no outrage from the demooocrats or repoooblicans.

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Get Moving
9:04 AM on February 15, 2011

Score: 6

One thing for sure is, the average American knows about zip on how to invest....too bad, because with a little research, you can do very well...

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