A Most Inefficient Theory
Debunking a core tenet of markets. Plus, a remarkable fraudster of yore.

The Myth Of The Rational Market
By Justin Fox
Collins Business, 400 pages, $27.99

Reviewed by Glenn C. Altschuler

AS THE ORIGINATOR OF “ALPHA,” THE risk-adjustment tool that became a mantra for hedge-fund managers, Michael Jensen maintained that the prices of stocks and U.S. Treasury bills reflect virtually all available data. His studies revealed that between 85% and 90% of information in corporate earnings reports found its way into prices before the reports were released, and that even the most skilled mutual-fund managers could not outperform the “efficient market.”

Formulated at the University of Chicago in the 1960s, the efficient-market hypothesis—that stock prices provide accurate signals for production and investment decisions—became a core tenet in business and finance in the United States at the end of the twentieth century. In this book, which is subtitled “A History of Risk, Reward, and Delusion on Wall Street,” Justin Fox, the economics columnist for Time magazine, provides a lucid, lively and learned account of the rise and fall of the theory.

A product of the search for a scientific model for financial markets, the hypothesis has for better and worse helped inspire index funds, modern portfolio theory, derivatives, and deregulation. Nonetheless, Fox demonstrates, it led policy makers and investors astray, most notably by undermining the notion that “the market is a devilish thing,” rendered imperfect and at times irrational by “the noise introduced by uninformed traders.”

Drawing on Thomas Kuhn’s great book The Structure of Scientific Revolutions, Fox explains that, in a classic case of cognitive dissonance, the community of academic finance rallied around the theory of efficient markets once it became entrenched, even when “hard-to-explain anomalies started cropping up within the paradigm.”

Studies showed that stocks with low P/E ratios did better than those with high ratios. And investors often behaved “like ocean-jumping sheep.” Though earlier sophisticated pricing schemes based on Value at Risk (VaR) or the capital asset pricing model (CAPM) gave a false sense of security or failed to explain historical returns, true believers continued to insist that no other proposition in economics had more solid empirical evidence supporting it than the powerful new model of efficient markets.

Ultimately, the myth of rational markets was blown away by bubbles. The valuation of dot-com companies and subprime houses throughout the irrationally exuberant 1990s, it turned out, had not been based on “fundamentals,” but, as they say in Las Vegas, “on the come.” After “it all ended badly,” Fox writes, even Chicago School “quants” admitted that financial markets don’t just set the price of securities and get out of the way. The way investors interpret a market’s behavior shapes that behavior—and “in turn determines the economic reality that market prices are supposed to reflect.”

And yet, Fox points out shrewdly, though they’ve poked some gaping holes in it, theorists and practitioners haven’t quite abandoned the edifice of rational market finance. They’re making do with a “muddle” of neoclassical and behavioral and experimental and asymmetric-information tools and techniques. More inclined now to study perturbations and biases, and to acknowledge that stability breeds instability, many of them still have faith that “pervasive forces are out there somewhere, pushing prices in the general direction of where they belong.”

Their models assume “rational but half-informed actors who make flawed decisions, but who are capable of learning and adapting.” And markets that are “the best aggregators of information known to man,” but do not reach a “perfectly calm equilibrium,” and occasionally go haywire.

Fox concludes with truism that remain essential even if they are obvious. Although the market isn’t exactly efficient, it’s hard to beat or to find a professional who can consistently do so.

Past performance may or may not be prologue. In short: It ain’t easy to predict the future.

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