

MARTIAL CAPITAL WHITEPAPER: WHAT ABOUT THE EFFICIENT MARKET HYPOTHESIS?



MARTIAL CAPITAL
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Those who believe in the Efficient Market Hypothesis, which includes the vast majority of professional investors worldwide, will say that it is impossible to sustain the kinds of returns Martial Funds has demonstrated in our backtest and in our short period of live investing. This White Paper talks about their concerns and our response.

The Efficient Market Hypothesis, developed by Prof. Eugene Fama at the University of Chicago in the early 1960s, says that everything that can be known about a stock has already been incorporated into the price of that stock. From this hypothesis have come many of the theories that we use to explain the financial markets: the arbitrage principles of Miller and Modigliani, the portfolio principles of Markowitz, the Capital Asset Pricing Model of Sharpe, Lintner, and Black, and the Option-Pricing Model that won for Black, Scholes, and Merton the Nobel Prize.

Investment professionals globally have embraced the Efficient Market Hypothesis. It is taught throughout the world in schools and in CFA licensing courses. It is used in particular by investment managers to explain their almost-index performance to their clients.

Virtually all of current day financial theory is based in one form or another on the Efficient Market Hypothesis.

The most important consequence of this hypothesis (for this discussion) is that it is not possible to outperform the market (adjusted for risk) over the long term. Random chance may allow a specific portfolio (a fund or privately-managed account) to do better in one year than the index, perhaps much better, but random chance will smile on some other portfolio manager next year so that over the long term, the hypothesis says, no managed fund can do better than the market.

Our reply is two fold:

- ▶ Look at the assumptions underlying the Efficient Market Hypothesis and judge for yourself if they are reasonable, and
- ▶ Look at our results.

WHAT ABOUT THE EFFICIENT MARKET HYPOTHESIS?

Among the assumptions the Efficient Market Hypothesis makes are:

- ▶ Investors are rational.
- ▶ Markets are rational.
- ▶ There are no taxes – or, more specifically, taxes play no part in financial decision-making.
- ▶ There are no transaction costs.
- ▶ An investor is indifferent between a dollar in dividends and a dollar in capital gains.
- ▶ A company (and its investors) are indifferent between a dollar of additional debt and a dollar of additional equity.

The list is much longer, but you get the point.

Our second argument is straightforward: How long does a fund have to convincingly beat the index before a follower of the EMH agrees that someone has proved they can beat the market? Between 1977 and 1990 – 13 years – Peter Lynch at the Magellan Fund achieved an average annual return of 29% after fees and expenses¹. Is that not an example of a fund having convincingly beaten the market?

The biggest problem for advocates of the Efficient Market Hypotheses is that many funds have proven they can outperform the market. Peter Lynch at Fidelity. The Harvard and Yale Endowment Funds. Warren Buffet. Our own Martial Funds have (with our backtest period plus our live experience) beaten the market every year since 1990 in the case of our Canadian portfolio, and every year since 1998 in our US portfolio. This could not be possible if the Efficient Market Hypothesis was true.

To reconcile this paradox let us look more closely at the academic studies that prove that no managed fund can beat the market over the long term. The essence of their argument is that there never has been such a fund. These studies show that the results of all managed funds looks more like a “random walk” than steady gains, which allows them to conclude that the Efficient Market Hypothesis must be true.

Is there any other possible explanation for the failure of the vast majority of managed accounts to do better than the market?

James O’Shaughnessy suggested the answer in his book, “What Works on Wall Street”. He pointed out that investment managers are inconsistent. They change their strategy to keep ahead of the market. They move to other jobs and are replaced by other managers with different strategies. They succumb to their investors’ short-term pressures. They make mistakes. They get fired.

¹ His successor managed to beat the S&P 500 by only 7%. After two years in charge of the Magellan Fund he left investing entirely and devoted his life to religion. Before joining Fidelity, Peter Lynch was a caddy at a country club. His successor was an MBA from Wharton.

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What the academic studies really proved, said O'Shaughnessy, was that the investment strategies were random, not the market itself. The erratic behavior of the investment management team was the cause of the random results of their funds.

Richard Feynman, Nobel Prize winning physicist, said about theories:

*"[The scientific method] is based on the principal that observation is the judge of whether something is so or not. All other aspects and characteristics of science can be understood directly when we understand that observation is the ultimate and final judge of the truth of an idea... If there is an exception to any rule, and if it [the exception] can be proved by observation, that rule is wrong."*²

The Efficient Market Hypothesis says that it is impossible to do better than the market (adjusted for risk) over the long term. Peter Lynch disproved the Efficient Market Hypothesis in 1990.

We at Martial Capital Ltd., the manager of the Martial Funds, believe that we cannot forget that the actual price of a stock is based on two people meeting by proxy on the floor of an exchange and that one of them is going to be disappointed an hour later. The key to investing profitably, we believe, is not to focus on the value of a stock, but on what the investing public thinks is the value of the stock. This is the essence of Behavioral Finance.

² *The Meaning of It All*, Richard P. Feynman. ISBN-13: 978-0465023943 These are a set of lectures given by Richard Feynman at the University of Washington in 1963.