Question investors should ask: Are stocks 'efficiently priced?'

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WHEN INVESTORS LOOK TO buy a stock, they are often looking for the holy grail - a stock that is a bargain because its fundamentals, like earnings-growth-rate and dividends, or its technical factors, like price momentum and share volume, indicate that it is worth more than its current market price.

The pursuit of a bargain is intrinsic to human nature, but much research suggests that true bargain stocks may be rarer than many investors and market pundits would like to believe. In fact, research suggests that the more critical question investors should be asking is: Are stocks "efficiently priced?"

Here, efficient pricing is a measurement of whether the stock’s market price reflects all the currently available information. While academics have been trying to answer this question for decades, many individual investors don’t understand why it is critical to them.

Consider the scenario in which some investors discern that a bid will be made to take over a company. These investors will be able to buy the stock from those who don’t have that information at a true bargain price.

Consider another scenario in which some investors discern that a stock’s earnings will be significantly below Wall Street expectations. They will be able to sell the stock to less knowledgeable investors for more than if everyone had that information.

Of course, there are laws against insiders trading on non-public information. However, there are no laws against trading more quickly than others on public information or making better inferences from publicly available information.

If stocks are efficiently priced, then legal market anomalies like those just mentioned should be evanescent and of little consequence to the typical investor.

However, if stocks are efficiently priced there are even more significant implications for investors. For example, any lasting change in a security’s price must be the result of new information becoming available. Other price changes must be just transient and random fluctuations.

This means that looking at past price and volume data can’t help an investor predict future stock prices and find bargain stocks. It also means the same about looking at current information about fundamentals. In other words, investors usually would be paying the correct price for a security and bargain stocks would be few and far between.
If stocks are not efficiently priced, then investors can take advantage of securities mispricing to earn additional returns. In essence, informed investors will earn additional returns at the expense of less informed investors.

While there is no definitive answer, the evidence appears to strongly suggest that the market does price most stocks efficiently most of the time. A useful book on the subject is "Beyond the Random Walk" by Vijay Singal. It crystallizes academic research into a readable discussion of pricing anomalies in "pockets" where the market appears to be inefficient.

The classic book popularizing efficient pricing of stocks is "A Random Walk Down Wall Street" by Burton G. Malkiel.

While these books are challenging, investors who read them will be repaid with a better understanding of securities markets and also with some new ideas on how to possibly earn extra returns on investments.

For example, Singal raises three key reasons why market inefficiencies exist:

Prices take time to fully reflect new information because obtaining and processing the information is costly.

In some areas, high trading costs prevent the timely correction of securities mispricing. If it costs a nickel to take advantage of a penny mispricing, the mispricing may continue for some time.

There is not an unlimited amount of capital available to correct mispricings. Often the extra return from a mispricing is small and investors might prefer to invest it to try to earn a large return from the overall market rather than a small return from the mispricing.

To these I would add a fourth reason: Investors aren't always rational. Sometimes they react like a herd and get caught up in market optimism or pessimism. This may result in long-lived mispricing because each investor is not making a truly independent decision. This behavior is one cause of market bubbles.