Wilfred Vos' Corner

Exploiting Market Inefficiency

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Investors can earn the most money by investing in assets that are not "informationally efficient"; the problem is finding assets that offer this rare opportunity. I will highlight an asset class that offers such an opportunity, but first let's quickly review some premises of efficient market theory.

In financial theory, the efficient-market hypothesis (EMH) suggests that capital markets are "informationally efficient," which means the current price of a stock already reflects all known information. In turn, EMH states that it is impossible to consistently outperform the stock market (i.e., earn an abnormal risk-adjusted rate of return) by using any information that the market already knows. Conversely, in order to outperform the stock market, you need to use information that the market doesn't know and that is not reflected in the price of the stock.

In short, you need to determine what factors might positively or negatively impact a stock's price – factors that no one is telling you – and you need to be right.

Thousands of analysts and professional investment managers spend countless hours researching various companies on a daily basis in an effort to identify stocks that are "mispriced" relative to all the information known about that company (because investors may not correctly account for all the known information). Stocks that are underpriced offer a great investment opportunity and stocks that are overpriced offer a great sell opportunity. Therefore, you will notice that companies announce "new" or "unknown" information either before or after the market closes, giving investors equal opportunity to revalue the company's future prospects and have this "new" information embedded into the price of the stock at the market up (possibly leading to big price changes at the market open). The more investors digest this continuous stream of information and adjust their actions accordingly, the more efficient the market (and the harder to earn an abnormally high risk-adjusted rate of return).

There are three common forms in which the EMH is commonly stated and each of these has different implications for how markets work.

1. **Weak Form Efficiency** implies that excess returns cannot be earned by using investment strategies based on historical share prices. Technical analysis will not be able to consistently produce excess returns, although some forms of fundamental analysis may still provide excess returns. This implies that future price movements are determined entirely by unexpected information and therefore are random.

2. **Semi-Strong Form Efficiency** implies that share prices adjust to "new" publicly available information very rapidly and in an unbiased fashion, such that no excess returns can be earned by trading on that information. Semi-Strong Form Efficiency implies that neither fundamental analysis nor technical analysis techniques will be able to reliably produce excess returns.

3. **Strong Form Efficiency** implies that share prices reflect all available information, public and private, and no one can earn excess returns.

Studies by Firth (1976, 1979 and 1980) have compared the share prices existing after a takeover announcement with the bid offer. Firth found that the share prices were fully and instantaneously adjusted to their correct levels, thus concluding that the stock market exhibited Semi-Strong Form Efficiency (especially in the United States): the market could efficiently respond to a short-term and widely publicized event such as a takeover announcement. However, his findings also suggested the market is less efficient at pricing stocks when factoring in long-term and amorphous factors.

In short, there are opportunities to earn a higher risk-adjusted rate of return by relying on active management within a public market, but you have to be competent and diligent.

Conversely, private markets (versus public markets) are less efficient primarily for two reasons:

1. **Lack of broad participation in the private transaction** – There is a limited amount of investors participating in private transactions versus public transactions.

2. **Investors use both public and non-public information** – Potential investors request and receive non-public information to make an investment decision regarding a private placement.

So, when investors make a private placement investment, they receive higher returns without necessarily enduring more risk. This occurs for the following reasons:

1. **Small deal premium** – Typically, private placements are smaller deals than a large Initial Public Offering (IPO).
2. **Less liquidity premium** – Although you can buy and sell a private placement, it is a little harder than buying and selling a publicly traded stock.
3. **Market inefficiency premium –** There are fewer market participants and fewer viable or less expensive options for companies to raise capital.

Therefore, private placements offer investors a unique opportunity to diversify their portfolio and earn higher rates of return by exploiting market inefficiencies instead of earning higher rates of return by taking more risk – because higher risk does occur from time to time.

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