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The degree to which a market can be considered “efficient” reflects the degree to which prices reflect all available information. It follows that the more participants with information there are in a market, the more efficient the market will be.

The question then becomes: do portfolio managers have information? Yes.

Portfolio managers gather facts (data) about firms in preparing their analyses. Such facts (data) are, by law, publicly available. It is in the interpretation of these facts through the process of security analysis that information is created. Different portfolio managers will analyze the same publicly available facts and reach different conclusions. These different conclusions are known as heterogeneous information.

The process of creating information (security analysis) leads to a more efficient market. The same facts can lead two different portfolio managers to buy or sell a security. This trade creates price discovery, which is the essence of an efficient market.

Now that we know that portfolio managers have heterogeneous information, the question is whether portfolio managers, with heterogeneous information, have enough influence over markets to make them more efficient.

In those markets where portfolio managers dominate trading, the answer will be yes. It is reasonable to expect portfolio managers to dominate equity and fixed-income markets, and when we think of “efficient markets,” these are the ones that come to mind. In fact, many practitioners have noted that the large-cap stocks are more efficiently priced (and harder to generate alpha on) than small-cap stocks. This reflects the fact that, by their nature, large-cap stocks are widely held (by many portfolio managers) and thus efficiently priced.

Perhaps it is less reasonable to expect portfolio managers to dominate commodity markets. In fact, commodity market participants are usually made up of commodity producers, commodity users, and a small number of speculators to help provide liquidity. It is also in commodity markets where we see some more extreme examples of volatility, perhaps because “portfolios” of commodities generally aren’t something that portfolio managers are asked to manage.

Portfolio managers create information and share that information by trading, which creates price discovery. Each price-discovery event makes the market more efficient. And it all starts with the portfolio manager. ▀

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Portfolio managers do not make markets more efficient for several reasons.

While the Efficient Market Hypothesis (EMH) has its theoretical merits, portfolio managers do not necessarily lead to more efficient investment markets in an applied setting. A variety of known anomalies exist that refute the EMH and detract from semi-strong-form market efficiency. Several less frequently discussed factors also influence portfolio managers and further refute the EMH.

First, market efficiency is based on the flawed assumption that all portfolio managers are rational and unbiased in the decision-making process. Managers have clearly shown the propensity to build portfolios driven heavily by emotion and bias. Recent research in behavioral finance theory shows that irrational investor optimism and/or pessimism have led to dramatic market inefficiencies. The technology bubble is a recent example.

Market efficiency also mistakenly assumes that all market participants have the same ability to collect all available market and nonpublic market information. While this premise might be true for S&P 500 stocks, it is generally not the case for most asset classes. For example, US small-cap stocks and emerging markets are segments where specialized managers have shown the ability to more effectively collect publicly available information and exploit inefficiencies.

Finally, the EMH falsely assumes that all portfolio managers are trying to outperform relative to a market benchmark, such as the S&P 500 Index. This is simply not the case, as many investors today are managing portfolios that ignore market benchmarks altogether. For example, some managers are building portfolios designed to generate more consistently positive absolute returns over time. As a result, these managers will assimilate security information far differently than do managers focused on relative return.

While the EMH has merit as a theoretical framework, there are exceptions in an applied setting that lead to meaningful inefficiencies that active managers are able to exploit. It is for this reason that some of the world’s most renowned investment managers have demonstrated the ability to either add value versus the market over long-term periods or to use the market in innovative ways to achieve unique investor goals. ▀

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Portfolio managers make the markets more efficient.

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