THE MARKET

The Market

The market feels, the market thinks, the market acts. We hear these anthropomorphic terms so often that we need to stop a moment to consider just what it means to say, essentially, that the stock market is both alive and humanlike.

No one uses these terms when referring to an ordinary market where people come to buy and sell goods. That market is just a physical locale; only a poet would ascribe human characteristics to the exchange of actual physical goods. Another type of market is a mere abstraction, referring to the intersection of supply and demand for anything. The market for bananas really means that some people produce bananas, some people consume them, and there is some process of exchange whereby price is determined and goods are delivered. This type of market can be good or bad, active, healthy or sick. But it would sound strange to hear that "the banana market feels…,", or "the banana market thinks".

The Stock Market

The stock market, however, is both a physical locale and an abstraction. A share of stock is not a certificate of ownership of a physical object or a specific technique. Rather, it means ownership of a part of an organization that produces goods and services. The market itself is crowded with actors, there is a blizzard of numbers, participants are bombarded with information about the economy, specific industries and particular companies. Any important new information can have an immediate impact upon the market in general or upon an individual stock. Additionally, the market is self reflective. Included in the flood of information are reports on the volume of trades, the history of price movements, various measures of "market sentiment" and endless ratios indicating the relation between one set of market statistics and another.

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It is the amount of information, the speed with which it must be processed, the self reflection, the intensity of the collective emotions combined with the abstraction of stock ownership that gives the market its human quality.

A Random Walk

The two fundamental views of the market are rooted in this analogy. The first is called the efficient market thesis and holds that the market is "rational". All available information regarding the economy and individual stocks is in the market's mind. Each investor has just some information but the market as a collective mentality has it all. Prices then are the end result of all of the information being weighed by potential buyers and sellers. Corollary to this idea is the assumption that no investor can have any superior skill in choosing stocks. A stock's potential return is already accurately reflected in its price, an individual investor can never have more than just some of the information needed to value the security. An early financial theorist, the French mathematician Louis Bachelier, made it explicit with what he called the "random walk" theory of stock selection. A random walk down Wall Street, a metaphor for randomly choosing stocks, will construct a portfolio which will do just as well as one put together using any sophisticated formula. The most famous illustration suggests we tack up a listing of all issues traded on the New York Stock Exchange, throw darts and buy the stocks that are hit. According to the theory this will do just as well as actually thinking about the stocks we buy. There is no record of any random walk theorist ever actually carrying out this experiment.

Modern Portfolio Theory

The other view looks to investor behavior and assumes that our actions are fundamentally irrational. In other words our investment choices are motivated by just about anything except reason. Economic behaviorists construct psychological tests to determine how much we are motivated by fear, weighed against how much we are moved by greed. They try to assess investors' grasp of arithmetic; do we understand that a $10 loss might be less than a 20% gain? Are we willing to sell a stock that has fallen by one-half when every indication is that it will continue to fall? Can we separate ego from our stock choices? What are the non-economic qualities of a stock that will attract more buyers, hence giving the stock a premium? Most important, how do we feel about risk?

Modern portfolio theory tries to quantify risk and includes that factor in the calculation of value. Stock A ordinarily follows the market. If the market in general goes up 10%, Stock A does too. If the market goes down 15%, Stock A is likely to do the same. Such a stock will be assigned a factor, called beta, of 1. Stock B on the other hand usually doubles the market's movement. If the market goes up 10%, B will go up 20%. Stock B gets a factor of 2. If B normally returns 12% it has the same value as A which normally returns 6% because 12 divided by 2 is equivalent to 6 divided by 1. In this manner modern portfolio theory tries to reconcile the emotion of fear with the cool calculation of investment return.

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Rational And Irrational

Both theories assume that what is "rational" is what adds up to the most money. The efficient market thesis sees the market as a kind of super brain, a whole greater than the sum of its individual investor parts. The market does the best job of processing information and hence of assessing value. It is supremely rational. Each investor is likewise rational but just lacks the market's mental capacity. Compared to the market, he can do no better than a random walk. This is what it means when investment gurus talk about the market as if it has a prescient though unconscious wisdom. It is simply articulating what we as individuals cannot see clearly.

Modern portfolio theory by contrast tries to gauge our emotional capacity for risk tolerance. We are "irrational" because we have emotions.

The two views can be reconciled with the simple observation that the market is irrational on a short term basis and supremely rational in the long term. Daily market activity is swayed by just about anything. Rumors, fears of disaster, the theory of the moment, all can move the market in entirely unpredictable ways. One day the fear of an oil crisis will drive the market down; oil prices will crush the economy. Another day the same fear will push the market up; scarcity will bring higher prices, hence greater profit. Just the idea that stocks are a great way to get rich will drive stock prices beyond all reason for several years. Similarly, a recent market crash can keep investors away even when prices are at fire sale levels.

In the long run, however, the market has to take account of two factors: corporate profits and interest rates. The market in its collective wisdom has to ask what it is willing to pay for a dollar of profit. It must measure this price against the price of alternative investments, like real estate or commodities. If ten dollars will buy a dollar of rent while a dollar of profit costs twenty, we can be sure that stock prices will fall and rental real estate values will rise. If an uncertain dollar of profit costs twenty dollars when a secure dollar of interest costs the same, the market has to ask what premium it will demand to compensate for the risk of profit. In other words, it has to reasonably assess the cost of the presumably irrational emotion of fear.

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