Back to Basics: Understanding Efficient Markets for Beginners

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today, we are going to go back to the basics. We're going to talk about efficient markets and what they are and maybe how you can invest in and around them. So this is part of our back to the Basics series that we do every Thursday. So that can help you become a better investor over the long term. So with that, let's go ahead and kind of dive in. So maybe we can define what is an efficient market and where does idea start? And maybe what are or what are they not?

Andrew [00:00:31]:

Yeah. So the question where the efficient market theory start? Not quite 100% sure. I would guess maybe Burton Malkiel or one of those writers talked about it. I don't know who first talked about it, but basically it's this idea that when you look at the stock market, there are just so many people trying to figure out, what's Apple worth, what's Google worth, what's Microsoft worth? Everybody's all putting their money in to try to say, well, I think Apple's worth 180 a share, or I think Microsoft's worth 350 a share. They're all making these bets. And because there's such a large group of individuals doing it, the people who are wrong tend to, like, cancel themselves out. And you get closer and closer to really what Apple is worth or what Google is worth. And so that's kind of the theory around the efficient market, as I understand it.

Andrew [00:01:26]:

How do you understand those ideas? And maybe you have a better way of explaining it.

Dave [00:01:31]:

No, I think you did a really good job. Kind of the way that I think about it is the theory is that all the information that's available, everybody knows. And so there's no air quote edge to be able to beat the

markets, because what somebody may know, other people already know. And so there's no particular edge. And so there's no way for individual investors to beat the market because all the necessary known information is already out there. And so there's nothing that can give you an edge over other investors, because the way the stock market works is one person buys, the other person sells on the other side of the trade. And the way the efficient market hypothesis posits is that when those two people go to each other, they both know the information about Apple. And so when one person is selling and the other person is buying, that offsets any sort of edge that could be there.

Dave [00:02:31]:

And so if Apple is going to earn 10% a year, then neither investor is going to benefit from the information they know about Apple. We're all going to earn 10% by investing or not investing in, in Apple. That's kind of the way I understand it, yeah.

Andrew [00:02:48]:

So it's really a theory or a hypothesis. I think it's been described. What have been your observations around it, and where do you stand on how you feel about it?

Dave [00:03:00]:

I'd say it's 50 50. It's 50% right and 50% wrong. And I think that the markets, for the most part, get it right a lot of the time. But then there are periods of time where it doesn't get it right. You have to remember that the market is full of human beings, people, and we all react to different news and information differently. And there are definite trends or market emotions that you can sense or see in different times of the markets. You know, when Covid hits, that was a very extreme black swan kind of event, and you could see the fear in the markets, and you could see everybody running for the doors, running for the hills, selling everything, because it's all going, you know, pecking a handbasket. Right.

Dave [00:03:51]:

So there was not a lot of rationality and involved in the reaction to everything. Was it scary? Of course it was. But were some of the overreactions to what was going on justified? Probably not. And I mean, on both sides of the table, there were companies that certainly benefited it from it, that got quite a bit of tailwinds from it, but there was also a lot of companies that got headwinds for it that maybe weren't justified. That, to me, was a perfect example of fear and greed in the market. Or you look at what happened during the 2007, 2009 great financial crisis, there was a lot of emotion involved in that. And, yeah, there's just been bubbles all over the place. You look@the.com bubble, you look at the more recent, more tech bubble, if you will, right after Covid.

Dave [00:04:42]:

So there was lots and lots of, you know, I guess, emotional reaction to us. I feel like there are definitely times where it gets right, but there's also a lot of times where it gets wrong.

Andrew [00:04:52]:

Yeah, 100%. I would argue, too, that it gets some companies wrong at some of the time. And if its clear when you look at just the wide range of price to earnings ratios, somebodys not valuing even take Apple, for example. Their earnings today are more valued than they were five years ago. Ten years ago, its the same company generating cash. All the companies are generating cash. But the value of that cash is different depending on how people feel about any given company. And so, you know, some of that's driven by, okay, well, Apple is a faster grower now than it was back then.

Andrew [00:05:34]:

But that's hardly a science. Just because Apple's grown, let's say, 10% a year doesn't mean it's going to grow 10% a year into the future. And you could pull ten people and maybe ten would all have a different opinion on where that reality will be. And so to me, I think there are times where the motions get really out of whack, and that's, I think, where you can have opportunity. So I'll give an example. I think it was in 2015, believe it or not, like, semiconductors were not in favor at all, especially semiconductor equipment companies. And so at that time, everybody thought, innovation's gone, we're approaching the limits to where these semiconductors can go. And so you're able to get, I was able to get lam research at like a, I don't know, 10, 12, 15 pe, something like stupid cheap.

Andrew [00:06:24]:

And that was with historical growth rates of double digits, like 15% a year. And so, you know, you fast forward to today, those same dollar of earnings that somebody like OM research is generating is worth two, three times more than it was back then. And not much has changed other than people's opinions on where they thought the tech was going to go. So I wonder if you see even more dislocations in tech more than anything else, because the opinions of that can be so different in so many different times.

Dave [00:06:57]:

Yeah, exactly. I guess another log I'll throw in the fire of maybe kind of disputing the efficient market hypothesis. Easy for me to say is Warren Buffett's career. You know, he's earned, he's generated almost 20% returns over a 60 year plus period, and that is beating the market by quite a lot. And he has been able to find

dislocations and value for different companies along the way, which has allowed him to generate market beating returns. And according to the theory, that shouldn't be possible. And there's a Whitney of investors that have followed in his footsteps, that have been able to do the same kinds of things. We have more recent people, like a Bill Ackman, or Terry Smith, or a guy spear or Monish purbrai, that have all been able to outperform their market for a long period of time.

Dave [00:07:52]:

And according to the hypothesis, not possible. And they've all done the same thing. They've found dislocations in value where the market is not reacting logically to what's going on with the company. And it doesn't mean that guy Spear knows more than somebody else about a particular company. It's behavioral. A lot of it's behavioral. And so it can be, there's lots of dislocation in the market. And to your point, it happens company to company.

Dave [00:08:21]:

Sometimes it happens by sector, sometimes it happens by different markets. The Dow Jones may be beaten up more than the Nasdaq, may be because the Nasdaq is more tech heavy than the Dow, or, you know, maybe markets outside the United States do better than the markets in the United States. And a lot of that just is because of human beings being involved. And, you know, to your point, they don't always agree that this is worth this much and this is worth that much. And whenever you have those discussions and disagreements, there's going to be a dislocation in a price, and it could be to the downside or it could be the upside. And depending on how you invest, then that's how you can benefit from those dislocations or those disagreements on what this is actually worth.

Andrew [00:09:07]:

Yeah, I've seen studies, I don't know which book. I feel like I've seen them in several books, saying that when you get a group of people together, any one person making some sort of estimate on something like, I don't know, pick like a jar of marbles, and everybody has to guess how many marbles are in here. You get somebody like me who's probably wildly inaccurate, another person who's like, way under guessed. But then if you have 40, 50 people on average, you're going to get pretty close. That's wisdom of crowds. And so you do have a lot of that in the stock market. But to your point, I think getting back to this idea of the fear and the greed and the emotions, it definitely plays a role. And I think just because there's an exception to the role doesn't mean the rules broken.

Andrew [00:09:53]:

But I think there's, there's been too many exceptions to the rule to say that you can't say that market's entirely efficient. I don't think that that's a good way to look at the stock market.

Dave [00:10:06]:
No.

Andrew [00:10:07]:
Over a long period of time.

Dave [00:10:09]:
No, it isn't. And you can see different times where the market sentiment turns against a particular company. And, you know, the negative view of meta a year ago really caused a dislocation in the price of the company. It dropped drastically. But if you looked at the overall performance of the business, it didnt change that much. As far as the revenue growth, the margins, what they were doing, it was mostly because people didnt like what Mark was doing, spending all the money on the metaverse thats still continuing. I mean, hes still spending the same amount on the metaverse that he was a year ago. But now, because its the air quote year of efficiency and people are more positive on the company, the stock price is, I dont know, 80, 90% up over the last year and a half or whatever crazy number it is, you cant tell me that thats efficient.

Dave [00:11:07]:
And so I think thats just a perfect example of how emotions can drive some of the narratives that you see about different companies. And you can go down the list of the top 50 in the S and P 500 and probably find some narrative that's going to drive positive or negative about the company. And that can really have a big bearing on the value of, not the value, but the price of the company and how that impacts your potential investment.

Andrew [00:11:35]:
I wonder how much the style ETF's play a role or just, you know, the factor ETF's in general, how much of that's driving markets?

Dave [00:11:45]:
I'm sure quite a bit, depending on the inflows and the outflows into those, yeah.

Andrew [00:11:50]:

Is it worth discussing that for beginners who maybe they're unaware of?

Dave [00:11:55]:

Yeah, I think so.

Andrew [00:11:57]:

Okay, so you have the ETF's baskets of stocks that you can buy, and you can buy, like we've said before, so many different flavors and shapes of ETF's. And so, you know, they have mutual funds that do similar things, but theres different factors that investors, institutional investors, fund managers, retail investors, different factors that they will use to try to build a portfolio and kind of taking a recipe of things and making a portfolio without having to get involved in individual names. And so theres things like growth baskets or value baskets or industry baskets. And some of those are driven by algorithms, formulas, some of them are managed where, okay, a stock does this and then it's either included or it's excluded, grows this much, or it stops growing that much. Okay, it's included or excluded. So you get, I mean, right now it feels like a lot of the growthier stuff's getting sold off. And I would argue irrationally, and it's weird to see some stocks just moving in tandem and you wonder if that's these factor ETF's or factor mutual funds, that they're driving a lot of this because one year maybe values in favor and the next year growths in favor, and you just, you know, dividends or not dividends, and just a myriad of different things. And that can, if you're having a whole group of stocks move, then by nature of that, one or two are not going to deserve those sell offs.

Andrew [00:13:26]:

But because of the way the market is constructed today, it feeds into that. And so I wonder if that creates some of the dislocations we see today.

Dave [00:13:34]:

Yeah, I would hazard to guess that that definitely plays a part because theres so much money moving in and out of those funds, because really its either individuals or its institutions that their mandate or their narrative is they have to beat the market. And so if something is hot, youre going to see a lot of money pile into that and that pushes that forward and that helps them generate better returns than something else. And when you're talking about industries or sectors or a basket of companies that are growing really fast right now, all you have to do is literally put the word AI in your investor report and you're going to see a 15% growth rate. It's definitely a hot area right now in the markets. People will create an ETF around that idea and then they'll push that, and then that becomes a big thing, and then that helps move the markets. But it also can, to your point, can dislocate different companies from that market that may not be seeing the same kind of growth

that maybe ten of the other companies in there, and they're just being pulled along the wave along the way. And I think that can help drive the returns that markets will see. And likewise it can flip on a dime and people will pile out of that into the other shiny thing, and then that will help drive returns.

Dave [00:14:57]:

And so it can kind of go back and forth. But a lot of it is being driven by institutional money as well as large individual investors putting a lot of money into these to try to help generate returns without having to pick individual companies. And it's a cheat code, I guess, that some people will try to use to try to generate returns. Yeah.

Andrew [00:15:21]:

How many cheat codes are out there? There's too many to count.

Dave [00:15:24]:

Yeah, way too many. Way, way too many.

Andrew [00:15:26]:

How many of them work?

Dave [00:15:27]:

Yeah, not a lot. That's what makes it hard. And that's why when you're picking individual companies, you need to look at the fundamentals of the business as opposed to focusing on what the narrative is on the company. It has a bearing on it, but you have to keep perspective, I guess, is the best way of putting it.

Andrew [00:15:45]:

So what's an investor to do about this whole efficient market thing?

Dave [00:15:50]:

Understand that the crowd has wisdom to it, but also understand that it can be driven by emotion, either good or bad. And you have to be cognizant of that. And you have to do research enough to understand what a particular business it is that you're buying and what's really driving the performance of the business. When we're buying stocks, we're really buying companies. And so when a company like Microsoft is executing on its plan, is performing well, is profitable, generating lots of returns, lots of cash flow, then that's going to be a

powerful business. Now, in some cases that may get priced up because everybody recognizes what a great business it is and they may, you know, the more people buy it, the higher the price is going to go on the business, which is great for you if you already own it. But if you want to get into it, then you have to, sometimes you have to wait. Sometimes you may just have to wait.

Dave [00:16:52]:

And because there is no company, no company that is worth any price and you have to manage that. And that's where some of the fear and greed could come into the market. And that's why you have to try to be patient. So understanding what it is that you're trying to buy and being patient are, I think the bigger aspects of trying to help counteract not only the efficient market hypothesis, but just the fear and greed that happens in the markets. What about you?

Andrew [00:17:19]:

Yeah, I love that idea. Understanding that the markets not always going to give you this great dislocation and youre not going to find these deals all the time. I think from a practical perspective, somebody whos trying to build wealth and theyre in that accumulation phase, I think dollar cost averaging, like we talk about putting the same amount of money into the market every single month as you do that, you understand that, okay, most of my investments are probably not the most greatest deals that we've ever seen in the history of the market. Maybe a lot of these are already efficiently priced. Maybe the growth rate that the market expects is what I'm going to get here. But when you do see those opportunities and you're patient for them, then you can gather up some money and back up the truck and load up into an opportunity. And that can be a great way to not maximize but amplify the returns that you get when you see an opportunity. And so I think thats one potential strategic way to try to take advantage of inefficiencies.

Dave [00:18:23]:

Yep, exactly. Thats exactly what Warren Buffett did with Apple when he bought it. It was trading at a twelve or 13 PE and it was generating lots of profits and lots of revenue. But the market sentiment about Apple was they were done. It was over and he bought it at a very, I guess low price, if you will. And he's held it for a long time and it's skyrocketed. It's over 50% of his portfolio now. And he didn't buy it at 50%.

Dave [00:18:54]:

He bought it probably at 25 ish percent or 15% of his portfolio. It just exploded that much. And to Andrews Point, it may or may not be the right thing to buy now because the market is efficiently pricing it now. Or could be. I dont know it well enough to know yes or no. Im just speculating so keep that in mind. But when Buffett bought it at the time that he did, it definitely was not being priced rationally and because the narrative

was had turned against the company irregardless of the fundamentals of how Apple was executing. And so that definitely has a bearing.

Dave [00:19:32]:

And I think that, you know, what Andrew was saying is you need to pay attention and you need to understand that just because you want to buy a company, Tesla, just because you want to buy it, doesn't mean that that's the right time to buy it. Sometimes you have to wait. And that's the hard part about investing, there's sometimes you have to wait. So I guess what are your thoughts on how investors can, I guess, learn what is a good time to buy something and not a good time to buy like what is efficient and what is not efficient?

Andrew [00:20:06]:

Yeah, I think there's no good way around this other than you got to learn the basics of valuation. Warren Buffett likes to talk about a burn the hands worth more in two in the bush. And when you're looking at what a stock or what a business should be worth, you're kind of taking that same concept. And so starting with a discounted cash flow model, I like to use that because a lot of the people who get brought up in finance are learning that and a lot of those people are buying and selling on behalf of their clients. And so that's the way the value things now and the math behind it has a lot of logic. And you're looking at what's the cash flow a company is generating, how much more are they going to generate in the future, and what are the two birds in the bush? What are the other options? So am I getting a really big bird or a little bird in my hand? And is that worth more or less than the two in the bush? That makes it hard. And I think that puts a little bit of a barrier to entry on if you want to be a stock picker. And you want to do things where you're trying to find inefficiencies and you're trying to buy things with a margin of safety at a low valuation.

Andrew [00:21:16]:

If you're not following the discounted cash flow, it's really hard to do that.

Dave [00:21:21]:

Mm hmm. It's really hard. It's really, really hard. And I think if you combine that with trying to be patient, remembering that you don't have to swing at every single pitch, and that using tools like dollar cost averaging, which can allow you to kind of smooth out the ups and downs as you're investing in companies, those can help you find, not only find these great companies and keep, maybe even keep them on a watch list. So it's not something that maybe you can pull the trigger on right now, but eventually the market will offer you up an opportunity and then you can take advantage of it. But if you don't understand the basics of valuing a company and trying to figure out how much it's worth, then you're going to struggle to know when the right time is to buy or not by the company. A lot goes into trying to figure out the value of a company, but

it's no different than valuing a home or valuing a car. When you go to buy those, you try to figure out what is this worth? And then try to figure out what's a fair price to pay for that in the stock, is this same thing when you buy a company like Microsoft, you have to figure out what is that worth? And using a discounted cash flow model is the best way that I know how to do.

Dave [00:22:34]:

And if Professor Demoder and Michael Mobison feel it's good enough for them and it's good enough for me.

Andrew [00:22:40]:

So where can people go to try to pick up some of that information?

Dave [00:22:45]:

Well, there's two places that we have done. Number one is our website, investingforbeginners.com dot. We have this huge search bar at the top, and Andrew and I have written a lot about valuation and about discounted cash flow models. I created a six day email course that you can sign up for for free, and that can teach you how to use a DCF model, how to build one, understand the components and the inputs. And then we've also created a little package evaluation, which is kind of an all encompassing package that includes models of dcfs as well as reverse dcfs and equity models and all kinds of stuff to help you value companies. And so those are three of the best ways that I know how to do it, I guess the fourth way is put in the reps. So to quote our, my friend John or Santi is put in the reps, do the work. The more that you do it, the easier it becomes and the more you'll understand what it is that you're trying to do.

Dave [00:23:41]:

And at some point you'll even be able to not maybe do them in your head a la Warren Buffett, but you'll certainly be able to see maybe before you finish where you think the value is going to end up.

Andrew [00:23:52]:

Yeah.

Dave [00:23:52]:

All right. Well, with that, we will go ahead and wrap up our conversation for today. I wanted to thank you guys for listening to back to the Basics series. And we talked about efficient market hypothesis today. Sounds very official, but really not. And this is a series that we've created that we're going to do every Thursday. So

come back next Thursday and we'll talk about another back to basics. And this is to help you become a better investor by kind of building on the foundations of investing.

Dave [00:24:18]:

So with that, we'll go ahead and sign us off. You guys go out there and invest with the margin of safety. Emphasis on the safety. Have a great week, and we'll talk to you all next week.

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