



*The (Irrational) Economist?*

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I recently wrote an article about the notion of efficient markets and theoretical and practical evidence against them:

<http://www.quantext.com/BeatTheMarket.pdf>

This article, also available via SeekingAlpha.com, met with enthusiastic response. The overall comments on this article confirmed my suspicion that many investors are interested in clarifying what financial theory says, and what it does not, about the ability of investors to out-perform the broad market indices. In the article, I explain why any investor can out-perform a market index like the S&P500 by combining broad asset classes that are somewhat uncorrelated to one another. Further, if you are willing to take on more risk than the index in question, it is absolutely trivial to out-perform the S&P500. All of this is completely consistent with standard investment theory. I was intrigued, then, to read an article in The Economist that starts with the following text:

**America is the home of the efficient-market hypothesis, which says financial markets have become so keenly contested that it is impossible for investors to keep beating them. Yet the very universities that peddle this theory so confidently also gleefully undermine it by doing precisely that: over one year and over ten, their endowment funds beat the S&P 500 and hammer most other institutional investors, including pension funds.**

*The Economist, Jan 20-26*

[http://www.economist.com/finance/displaystory.cfm?story\\_id=8559799](http://www.economist.com/finance/displaystory.cfm?story_id=8559799)

Now, I have not read the study that they cite in the article, which documents how the endowments have performed. The study itself is not the point of my comments. After reading the introduction to the article above, you might expect that The Economist would show that these endowments have somehow beaten the efficient market hypothesis---as they suggest in the introduction. You would be disappointed. The article goes on to say that (1) the endowments have beaten the S&P500, (2) that the endowments have a higher risk tolerance than many other investors, and (3) that endowments are investing in a range of asset classes that are not highly correlated to the U.S. equity markets. The article also states that many endowments have added highly illiquid assets to their

portfolios, and illiquidity increases risk, too. This is called, not surprisingly, liquidity risk. The data that the article provides to suggest out-performance is the average rate of return from endowments of various sizes vs. the S&P500. Yes, the average endowment has generated higher average returns than the S&P500. If you select assets by randomly throwing darts at a listing of funds that include commodities, foreign and emerging markets, etc. and you allow the final portfolio to have more risk than the S&P500, you will also out-perform the S&P500. In my article about market efficiency (cited at the start of this article), I showed that a naive portfolio which was simply equally allocated to the S&P500 (SPY), REIT's (ICF), utilities (IDU), bonds (TIP), and emerging markets (EEM) has dramatically out-performed the S&P500 over recent years. This out-performance says nothing about whether or not the efficient market hypothesis is correct.

To generate higher returns than the S&P500 when you can add asset classes with low correlation to the S&P500 and also potentially have a higher level of portfolio risk than the S&P500 is not evidence of the talent of managers, nor does it say anything that would “undermine” the efficient market hypothesis. My point here has nothing to do with whether or not the endowments in question have, in fact, out-performed or whether the managers are out-smarting the market with better investment choices. *The Economist* article itself is spinning out an argument that is meaningless--and this is a magazine that is read by people who are far more numerate than the average investor. For *The Economist* to publish an article that so badly mangles the notion of what it means to “beat the market,” what does this tell us?

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