PROPHETS

Markets Are Right More Often Than You Think

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By Ben Carlson

It seems that a week -- or even a day -- doesn't go by without an article story or research report asserting that investors are ignoring a huge risk or potential black swan in the markets. In recent years, there have been warnings about higher than average valuations, falling rates, rising rates, demographics, peak profit margins, China's hard landing, Brexit, double-dip recessions, debt ceilings, margin debt, money printing, elections and much more.

Investors tend to be a confident bunch. No matter what happens or is expected to happen in the markets, economy or geopolitics, the majority of market participants assume that they will be the ones to profit, yet simple math says this will never be the case. Investors would be wise to understand who is on the other side of their trades. Although it's easy to assume we can handicap everything that's going on in the markets, we should approach them with a humble attitude.

There are millions and millions of market participants who buy and sell securities every day. All have competing goals, time horizons, risk appetites and investment philosophies. But this is how markets are made and prices set. The number of trades that sets these daily market prices is staggering.

In 2015 alone, world equity markets averaged almost 99 million trades, accounting for almost $450 billion a day, according to Dimensional Fund

Advisors, Take the SPDR S&P 500 ETF, an exchange-traded fund that tracks the Standard & Poor's 500. Its three-month daily average trading volume for is 88,218,539 shares through mid-January. For 2016, it averaged 104,904,708 shares traded a day, or more than $22 billion in turnover. For the underlying S&P 500 constituent stocks, the three-month daily average trading volume is 600,116,291; the average for 2016 was 641,398,857. Apple itself averages more than 30 million shares traded every day.

Last year my colleague Barry Ritholtz interviewed Burton Malkiel, author of "A Random Walk Down Wall Street," for his Masters in Business podcast. Malkiel explained why it's so difficult to predict where all these trades will take the markets:

> What efficient markets are associated with which is wrong is that efficient markets mean that the price is always right – that the price is exactly the present value of all of the dividends and the earnings that are going to come in the future and the price is perfectly right. That's wrong. The price is never right. In fact, prices are always wrong. What's right is that nobody knows for sure whether they're too high or too low. It's not that the prices are always right, it's that it's never clear that they are wrong. The market is very, very difficult to beat.

I'm not suggesting that markets are perfectly efficient. Anyone who invested during the financial crisis and subsequent recovery could tell you that. Markets will never be completely efficient because humans are making the buy and sell decisions and humans are often wildly irrational. The problem is that far too many investors believe they will know exactly when this irrationality will start or end. The author and behavioral finance professor Meir Statman once said, "The market may be crazy, but that doesn't make you a psychologist."

It’s easy for investors to claim that market prices don’t make any sense because it’s often true: Market prices don’t make sense most of the time. But the job of any successful investor is not to spend their time pointing out this fact. The job of a successful investor is to understand why prices are where they are. Every single market environment is different. Investors need to calculate probabilities from the past, but they also need to analyze the present to provide context for understanding the current situation.

Investors are constantly questioning whether the market is wrong. It would be far more helpful if more investors also questioned whether they are wrong about the markets.

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