Douglas Capital Management, LLC

FAQ: Efficient Market Theory

Several potential clients have read books about Efficient Market Theory or the Efficient Market Hypothesis. Efficient market theorists would have you believe that Warren Buffet, George Soros, and Peter Lynch were just "lucky". The belief goes that if enough people were trying to make money in the stock market, a few would out of sheer luck make billions while the majority would make very little. Wikipedia has a very good and I believe unbiased article on the efficient market hypothesis. You can find it here.

Have You Read A Random Walk Down Wall Street?

> I first read the A Random Walk Down Wall Street in the early 90's. It was one of the first books I read on investing, so at the time, the author appeared to make some very good arguments for Efficient Market Theory. I was sufficiently convinced by his arguments that I bought Vanguard Index Funds from 1993 through 1996.
>
> However I read a much better book in 1996, What Works on Wall Street by James O'Shaughnessy. James O'Shaughnessy did a thorough study of historical stock market data from 1954 through 1994 and showed that very simple stock selection strategies could be used to provide significantly higher (or lower) risk-adjusted returns than the stock market as a whole. In my opinion, his study and others like it shattered the Efficient Market Hypothesis, and the Capital Asset Pricing Model as well.
>
> His book and several research papers led me down the path to active portfolio management. I highly recommend it to anyone interested in stock market investing.
>
> The ideas espoused in A Random Walk Down Wall Street are a form of intellectual laziness that take the position "Nobody can make better decisions based on financial data than the others who have access to the same data, so there is no use trying"
>
> Some books that I would highly recommend that go entirely against that mindset:
>
> What Works on Wall Street - by James O'Shaughnessy
>
> Freakonomics - by Steven D. Levitt and Stephen J Dubner.
>
> The Econometrics of Financial Markets - by John Y. Campbell, Andrew W. Lo, and A. Craig MacKinlay
>
> Bringing Down The House - by Ben Mezrich

If you like graduate-level mathematics, you will enjoy The Econometrics of Financial Markets, if you want to be entertained, start with Freakonomics and Bringing Down the House.

All of these books provide examples of how one can draw interesting conclusions and formulate strategies by applying enough thought and study to seemingly random data sets.

Have You Read "Fooled by Randomness" or "Black Swans"?

I have read "Fooled by Randomness". So far the key points I have taken from the book are:

Very few people have both the mathematical skills and the common sense or street smarts to succeed over the long term at trading stocks, bonds, and options.

Very few people have an adequate understanding of probability to understand the risks they are taking.

Very few people behave rationally when it comes to controlling risk.

The media does nothing but generate "noise" that interferes with rational decision making. Some traders and investors are overly influenced by the "noise" from the media.

So far, the author has a very low opinion of the majority of active traders I am competing with, so the book was all good news to me.