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Does the Stock Market Overreact?: Discussion

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## DISCUSSION

PETER L. BERNSTEIN\*: Werner de Bondt and Richard Thaler have developed an elaborate set of statistical data to demonstrate what market practitioners have been insisting upon for a very long time indeed: equity valuation errors are systematic and therefore predictable. While I find the reasoning in their paper to be convincing and their test results to be most impressive, the authors fail to recognize some elements of the marketplace that would enrich their analysis and that—just maybe—might help investors to break their unfortunate habits.

The objective of the paper is to demonstrate the consistency with which investors push stock prices to unsustainable levels—in both directions. They habitually extrapolate recent earnings trends into the future, ignoring the many random walk elements in earnings patterns as well as ignoring the tendency of most divergences from average earnings performance to correct themselves over time by a familiar process known as reversion to the mean. This tendency ultimately leads to painful disappointment for the optimists who have pushed the prices of rapid-growth companies too high while, at the same time, it leads to pleasant surprises for the pessimists who have pushed the prices of troubled companies too low.

The analysis gives rise to two critical questions. First, why is it that contrary investors are so few in number or market power that the overreaction to new earnings information is allowed to persist for so long? Are investors really that dumb? Second, in what sense does this phenomenon justify the accusation that the market is “inefficient”?

De Bondt and Thaler make passing reference to Keynes’s complaint that “day-to-day fluctuations in the profits of existing investments. . . . tend to have an altogether excessive, and even an absurd, influence on the market” (1936, pp. 153–154). Yet, that is precisely where we can unlock the mystery of the persistence of the overreaction effect.

Keynes characterized the market as a beauty contest in which each investor’s objective was not to pick the girl that he or she thought was the prettiest but, rather to pick the one that *other* investors would consider the prettiest. The deep meaning of this metaphor is that investors forecast stock prices instead of company earnings. More precisely, today’s price is a forecast of what investors expect tomorrow’s price to be, rather than an estimate of the present value of future payments streams.

But this leads to two further questions. First, why does this emphasis on capital gains give “day-to-day fluctuations in the profits of existing investments [an] excessive, and even absurd, influence”? Second, why are investors so stubborn about changing their ways? After all, Keynes wrote about all this nearly fifty years ago, and the leopards have not changed one of their spots. Why are investors in such a hurry?

Uncertainty is the crucial ingredient in the answer to these questions. Stocks are risky assets. You can overcome some of the uncertainty, or reduce the risk, when the dividend yield on stocks is *very* high—or, to be more technical, when

\* Peter L. Bernstein, Inc. and *Journal of Portfolio Management*.

their duration is *very* short. In fact, however, the mean yield on stocks over the past 100 years has been less than 5%. Stock yields have been comfortably below bond yields for the past twenty-five years. Furthermore, as Molodovsky [5] pointed out a long time ago, those postwar years from 1947 to 1959, when dividend yields were so far above bond yields, were sports in the history of capital markets and by no means consistent with prewar behavior.

As a consequence, risk-averse investors, faced with the inherent uncertainty involved in estimating the present value of the future payments stream, will inevitably look to shorter term price changes for the largest part of their return from equity ownership. As Hamlet put it, "The undiscover'd country . . . makes us rather bear those ills we have than fly to others that we know not of."

Investors will therefore put more emphasis on new and easily understood information with immediate consequences than they will put on the less readily decipherable types of information with longer run consequences. This pattern of behavior seems to me to be such an inescapable feature of equity ownership that the evidence supporting the beauty contest and the overreaction effect should come as no surprise at all. Indeed, *this is the way we should expect any market characterized by long-duration assets to work.*

This analysis suggests that most of the arguments about market efficiency are badly specified. De Bondt and Thaler state in their very first sentence that security markets are "viewed by most economists as paragons of market efficiency." They then attempt to demonstrate that the market is inefficient in a long-run sense, but that is different from arguing that security markets are inefficient in a beauty contest sense.

I would argue that the stock market in particular is highly efficient in rapidly incorporating information that would have an effect on prices in the short run, even if it fails to process more complex and longer run information in an efficient manner. This is precisely why so many investors who follow the news have such disappointing results while the followers of the P/E anomaly, the dividend discount model, Benjamin Graham Strategies, and other systematic methods of contrary investing have superior results.<sup>1</sup>

In sum, then, the market will naturally provide arbitrage opportunities from long-run inefficiencies, but only a few investors have the necessary psychological attitudes and will accept the necessary investment horizons to perform as true long-term investors. On the other hand, if most investors ever developed those attitudes and revised their investment horizons, the long-run inefficiencies would disappear. Until then, let us give the Efficient Market Hypothesis its due as an explanation of how markets work in the short run, even if we can probably reject the hypothesis for the long run.

<sup>1</sup> I am grateful to Kosmicke [4] and Andersen [1] for their outstanding articles on this subject and for bringing this view of the matter to my attention.

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