Efficient Markets and Betting Against Market Distortions

Markets are generally efficient in aggregate and over time. Markets can be inefficient in parts or for periods of time. Do I really believe this? Yes, provided they are proper markets by which I mean that there are sufficiently numerous independent participants, neither of which has sufficient individual influence over pricing.

Most of the familiar asset types exhibit these properties. Equity markets are a good example. So are corporate credit markets. The persistent performance of a small group of hedge fund managers, and the disappointing performance of the significant majority of their competitors is instructive. Successful equity hedge fund managers are rare. Credit managers tend to display more persistent out performance. The liquidity, symmetry of information, completeness of markets in equity markets tends to level the playing field. They also make inefficiencies small, relative to background noise, complicating the job of the equity investor. Here is another point. Every market has a level of background noise. Inefficiencies have to be larger and more persistent if they are to be captured by an investor. If the inefficiencies are too small or last too short a time, then by definition these markets are too efficient. This could be one measure of the efficiency of a market. That some investors are able to repeatedly beat the market implies that there are inefficiencies but that they may not be obvious enough for the majority to identify or capitalize on.

Cross asset inefficiencies are an example of how apparently efficient markets can be inefficient because they are in fact incomplete. Capital structure arbitrage is evidence of such inefficiencies. Because efficiency in equities and bonds are policed by different constituents whose pricing models do not look across asset classes, the valuation between different parts of a company's capital structure may be mispriced and provide the suitably equipped investor arbitrage or relative value opportunities. This strategy is especially topical under the current cosh of increased regulation in the form of **Basel** 3, Solvency 2, Dodd-Frank and the Volcker rule. The best policing of capital structures used to be the proprietary trading desks of the investment banks. With increased regulation, prop desks are being shrunk or closed, reducing the amount of capital policing cross asset no-arbitrage conditions in the markets. The opportunities for arbitrage and relative value are greater now than ever before. In other words, markets are a lot less efficient these days.

There are other reasons why a market may be persistently inefficient. The existence of one or a group of participants with disproportionate influence can distort pricing. A simple example is a regulator or central bank. Under what was apparently regarded as normal conditions, central banks may unilaterally determine or influence the level of short term interest rates. While this is already a deviation from the assumption of market determined prices an even greater departure is if the said central bank additionally influences other maturities along the yield curve, for example through the open market purchases of government bonds we have come to call Quantitative Easing or QE. Under these conditions the market is far from perfect and no-arbitrage pricing should not be expected to hold. Investors trading on the assumption of efficient pricing are likely to be confounded.

Extending the complete markets argument for inefficient markets, one could argue that price distortion in one market can affect prices in other markets. A current example is equity markets. Investors consider equity valuations reasonable on an equity yield gap basis, that is relative to US treasuries. If, however, the yield curve is being artificially suppressed by the actions of the central bank, such as under the unconventional monetary policy we call QE, then equities are vulnerable if the central bank were to reduce or stop their purchases of US treasuries and the yield curve was to find its natural level.

Another instance where markets are temporarily inefficient are times or high uncertainty and turbulence where information is insufficient for the market to digest and interpret. Times of crisis and near crisis often lead to the inversion of credit default term structures, for example, making it more expensive to insure against default over a shorter period than over a longer period. US treasury bills may at times trade at higher yields than the unsecured LIBOR market in a recent example, when default by the US treasury seemed possible, albeit highly improbable.

In some markets, imperfections are more prevalent or persistent. Securitized markets such as mortgages, auto loans, student loans, and credit cards are a good example. Complexity of products, market conventions, market culture and regulation make the securitized products market a highly peculiar one. The highly contrived nature of the products being traded are the root of the overall complexity of the market, if it can even be called a market. The highly politicized nature of the underlying assets in which the derivative products are based also invite complex and confusing regulation driven by the confluence of politics, socio-economics and commercialism. One of the results is one of the largest, most liquid asset markets in the world: agency mortgage backed securities. Yet size does not an efficient market make. The best traders in mortgage markets are those who have been involve in the regulation or the industry, the production of the securities, the distribution of product and the origination and management of the underlying assets being securitized. They are bonds indeed, but not as we conventionally know it. Fixed income investors uninitiated to the peculiarities of the MBS market but lured by the high yield, high ratings, often struggle to trade an entrenched club of insiders.