



Why Analyze Securities?

Security Analysis - Does it Matter?

Wall Street has scores of analysts, strategists and portfolio managers hired to do one thing: beat the market. Analysts are hired to find undervalued stocks. Strategists are hired to predict the direction of the market and various sectors. Portfolio managers are hired to put it all together and outperform their benchmark, usually measured as the S&P 500. Granted, there are many studies and disputes raging on the performance of equity mutual funds, but it is safe to assume that about 75% of equity mutual funds underperform the S&P 500. With these kinds of stats, individual investors would surely be better off simply investing in an index fund rather than attempting to beat the market. But that wouldn't be any fun, would it? After all, half the fun is actually doing the analysis.

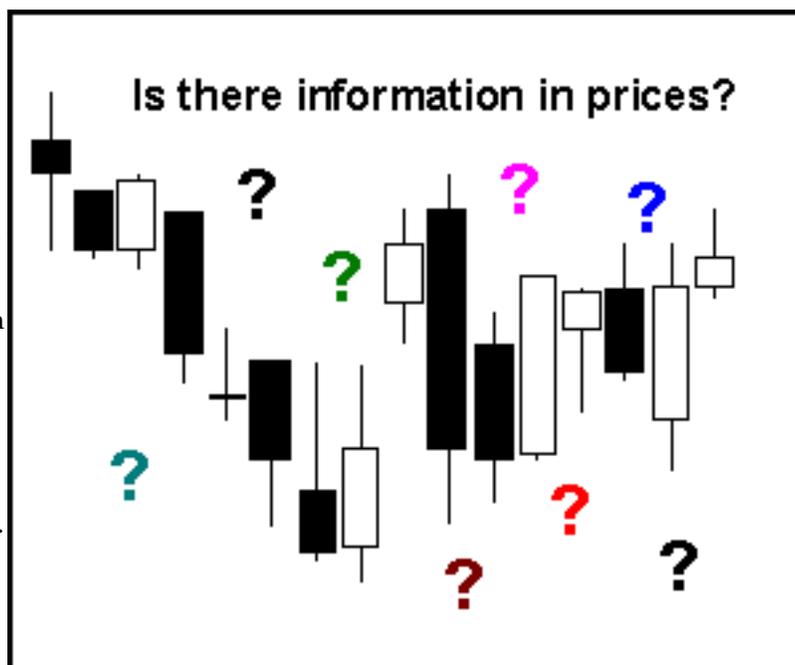
The added value of analysis is in the eye of the beholder. A fundamental analyst believes that analyzing strategy, management, product, financial stats and many other readily and not-so-readily quantifiable numbers will help choose stocks that will outperform the market. They are also likely to believe that there is little or no value in analyzing past prices and that technical analysts would be better off star gazing. Star gazing! Hmmmph. The technical analyst believes that the chart, volume, momentum and an array of funny and not-so-funny indicators hold the keys to superior performance. In addition, the technician might add that fundamentals are hogwash pure and simple. There is good news though. The battle between fundamental analysis and technical analysis has been settled by the Random Walk theory. The Random Walkers (no relation to Jeff Walker of the [Walker Market Letter!](#)) believe that both are useless as is any attempt to try and outwit the market.

So whom do we believe? Is fundamental analysis worth the time and effort? Are technicians a bunch of quacks? Or is it all a lesson in futility? First, it will help to look at the efficient market hypothesis and see where the fundamentalists, technicians and Random Walkers stand on the question of market efficiency. After we have explored this area, we will then take a closer look at the random walk theory, fundamental analysis and technical analysis.

Are Markets Efficient?

The question concerning the value of analysis begins with the debate on market efficiency. Just what is represented by the current price of a security? Is a security's current price an accurate reflection of its fair value? Or, do anomalies exist that allow traders and investors the opportunity to beat the market by finding undervalued or overvalued securities?

Aswath Damodaran, of the Stern Business School at NYU, defines an efficient market as one where the market price is an unbiased estimate of the true value of the investment. Fair enough, but it is not quite that simple. In an efficient market, the current price of a security fully reflects all available information and is the fair value. "All" because the price is the sum value of all views (bullish, bearish or otherwise) held by market participants. It is the fair value because the market agreed on a price to buy and sell the security. As new information becomes available, the market assimilates the information by adjusting the security's price up (buying) and down (selling). In an efficient market, deviations above and below fair value are possible, but these deviations are considered to be random. Over the long run, the price should accurately reflect fair value.



The hypothesis further asserts that if markets are efficient, then it should be virtually impossible to outperform the market on a sustained basis. Even though deviations will occur and there will be periods when securities are over- or undervalued, these anomalies will disappear as quickly as they appeared, thus making it almost impossible to profit from them.

From experience, most of us would agree that the market is not perfectly efficient. Anomalies do exist and there are investors and traders that outperform the market. Therefore, there are varying degrees of market efficiency, which have been broken down into three levels. These three levels also happen to correspond to the beliefs of the fundamentalists, technicians and random walkers.

Strong-form: Technicians

The strong-form of market efficiency theorizes that the current price reflects all information available. It does not matter if this information is available to the public or privy to top management; if it exists at all, then it is already reflected in the current price. Because all possible information is already reflected in the price, investors and traders will not be able to find or exploit inefficiencies based on fundamental information. Generally, pure technical analysts believe that the markets are strong-form efficient and all information is reflected in the price.

Semi-Strong Form: Random Walkers (academics)

The semi-strong form of market efficiency theorizes that the current price reflects all readily available information. This information will likely include annual reports, SEC filings, earnings reports, announcements and other relevant information that can be readily gathered. However, there is other information not readily available to the public that is not fully reflected in the price. This could be information held by insiders, competitors, contractors, suppliers or regulators, among others. Anomalies exist when information is withheld from the public and the only way to profit is by using information not yet known to the public. This is sometimes called insider trading. Once this information becomes public knowledge, prices adjust instantaneously and it is virtually impossible to profit from such news. Academics and Random Walkers believe that the markets are semi-strong efficient. Prices reflect public information and it is virtually impossible to profit from this information.

Why do academics believe it is not possible to profit from efficient markets? There is an old joke among economists that relates to market efficiency. Two economists are walking down the street and one spots a \$20 bill lying on the ground. He turns to the other economist and says, "Look, a \$20 bill". The other economist looks at him in disbelief and answers, "If it were a real \$20 bill, someone would have already picked it up". Academics feel that if a security is selling for 10 and one year from now it will be worth 20, what is to keep it from going to 20, or at least 18 immediately? If it were really worth 20 in one year, the price would reflect this today.

Weak-form: Fundamentalists

The weak-form of market efficiency theorizes that the current price does not reflect fair value and is only a reflection of past prices. Furthermore, the future price cannot be determined using past or current

prices (sorry technical analysts). Fundamental analysts are champions of weak-form market efficiency and believe that the true value of a security can be ascertained through financial models using information readily available. The current price will not always reflect fair value and these models will help identify anomalies.

Which Form Exists in the Market Today?

Many in academia, including Gordon Gemmill of London City University Business School and Aswath Damodaran of NYU, believe that security prices are semi-strong efficient. Recall that semi-strong efficient implies that all public knowledge is reflected in the price and it is virtually impossible to exploit deviations from the true value based on public information. Only new information will affect the price. Judging from the reaction of many stocks to news events, there seems to be evidence to support this case. The flow of information has become faster with the internet and surprises are factored in instantly. Few will argue that a surprise, both positive and negative, can violently move the price of a security. A few examples include:

- After pre-announcing that earnings would come in below expectations on 6-Jan-00, Lucent fell from 73 to 53 in one day.
([Current SharpChart for Lucent](#))



- After positive comments from an influential analyst on 23-Feb-00, AOL shot up 49 to 59 in 2 days.
([Current SharpChart for AOL](#))



- After reporting earnings that were below expectations on 15-Feb, Abercrombie and Fitch fell from 24 to 15.
([Current SharpChart for Abercrombie and Fitch](#))



Even though these are but a few examples, it is obvious that new information can move the price of a security. Many academics also argue that price movements are largely random and only influenced by the introduction of new information. Many academics do acknowledge that some drift exists in security prices, but never a trend. Random, are prices really random?

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