

Title: NO FREE LUNCH; SEVEN HABITS OF HIGHLY DEFECTIVE INVESTORS

Summary: I like the theory of efficient financial markets as much as anyone. I don't begrudge Robert Merton and Myron Scholes the Nobel Prize they just received for showing how that theory can help you price complex financial instruments. But unless you spent the past five months in a Tibetan monastery, you must have noticed that markets have been behaving pretty strangely of late. As recently as June the "miracle" economies of Southeast Asia could do no wrong--investors cheerfully put billions into local stock markets. By October those same investors were in full flight; after all, everyone could see how corrupt and badly managed those economies were. When the IMF and the World Bank held their September meeting in Hong Kong, everyone congratulated the hosts on their economic policies, which had insulated them from the turmoil to the south and maintained prosperity through the handover to China. A month later Hong Kong had not only crashed but had briefly brought Brazil and much of the rest of the world down with it.

Source: FORTUNE

Date: 12/29/1997

Price: Free

Document Size: Short (1 or 2 pages)

Document ID: SG19990714110011335

Subject(s): ECONOMY; INVESTMENTS
Investing; Industries

Citation Information: (ISSN 0015-8259) VOL. 136 NO. 12/1998 INVESTOR'S GUIDE/ SPECIAL YEAR-END DOUBLE ISSUE page 44+
FIRST: ECONOMICS

Author(s): PAUL KRUGMAN

NO FREE LUNCH; SEVEN HABITS OF HIGHLY DEFECTIVE INVESTORS

I like the theory of efficient financial markets as much as anyone. I don't begrudge Robert Merton and Myron Scholes the Nobel Prize they just received for showing how that theory can help you price complex financial instruments. But unless you spent the past five months in a Tibetan monastery, you must have noticed that markets have been behaving pretty strangely of late. As recently as June the "miracle" economies of Southeast Asia could do no wrong--investors cheerfully put billions into local stock markets. By October those same investors were in full flight; after all, everyone could see how corrupt and badly managed those economies were. When the IMF and the World Bank held their September meeting in Hong Kong, everyone congratulated the hosts on

their economic policies, which had insulated them from the turmoil to the south and maintained prosperity through the handover to China. A month later Hong Kong had not only crashed but had briefly brought Brazil and much of the rest of the world down with it.

What is the market up to? Well, I recently had a chance to listen to the market, or at least a fairly large part of it, when I attended a meeting of money managers. Collectively they control several hundred billion dollars, so when they talked, I listened. Mainly I wanted to know why such smart men and women--and they must be smart because if they aren't smart, why are they rich?--do such foolish things. Here's what I learned: the seven habits that help produce the anything-but-efficient markets that rule the world:

1. Think short term. A few people in that meeting tried to talk about the long term--say, about what kind of earnings growth U.S. corporations might be able to achieve over the next five years. This sort of thing was brushed aside as too academic. But wait: Any economist will tell you that even a short-term investor should look at the long run. This year's stock price depends on this year's earnings plus what people think the price will be next year. But next year's price will depend on next year's earnings plus what people next year expect the price to be the following year.... Today's price, then, should take into account earnings prospects well into the future. Try telling that to the practitioners.

2. Be greedy. Many of the people kept talking about how they expected a final "melt-up" in prices before the big correction and how they planned to ride the market up for a while longer. Well, maybe they were right, but if you really think stocks are overvalued, how confident should you be about your ability to time the inevitable plunge? Trying to get those extra few percent could be a very expensive proposition.

3. Believe in the greater fool. Several money managers argued that Asian markets have been oversold, but that one shouldn't buy in until those markets start to turn around--just as others argued that the U.S. market is overvalued, but they didn't plan to sell until the market started to weaken. The obvious question was, If it becomes clear to you that the market has turned around, won't it be clear to everyone else? Implicitly, they all seemed to believe that the strategy was safe, because there is always someone else dense enough not to notice until it really is too late.

4. Run with the herd. You might have expected that a group of investors would have been interested to hear contrarian views from someone who suggested that the U.S. is on the verge of serious inflationary problems, or that Japan is poised for a rapid economic recovery, or that the European Monetary Union is going to fail--which would have offered a nice challenge to conventional wisdom. But no: The few timid contrarians were ridiculed. The group apparently wanted conventional wisdom reinforced, not challenged.

5. Overgeneralize. I was amazed to hear the group condemn Japanese companies as uncompetitive, atrociously managed, unable to focus on the bottom line. But surely it can't be true of all Japanese companies; guys who managed to export even at 80 yen to the dollar must have at least a few tricks up their sleeves. And wasn't it only a couple of

years ago that Japanese management techniques were the subject of hundreds of adulatory books and articles? They were never really that good, but surely they are better than their current reputation.

6. Be trendy. I came to the meeting expecting to hear a lot about the New Economic Paradigm, which asserts that technology and globalization mean that all the old rules have been repealed, that the inflation-free growth of the past six years will continue indefinitely, that we are at the start of a 20-year boom, etc. That doctrine is basically nonsense, of course--but anyway I quickly determined that it is, as they say in Buffy the Vampire Slayer, "so five minutes ago." All the rules have changed again: Now we stand on the brink of a dreadful epoch of global deflation, and despite its previous track record of engineering recoveries, there is nothing the Fed can do about it. You see, it's a new new economy.

7. Play with other people's money. If, as I said, the people at that meeting were very smart, why did they act in ways that seem so foolish? Part of the answer, I suspect, is that they are employees, not principals; they are trying to make money and careers for themselves. In that position, it is hard to take a long view: In the long run, even if you aren't dead, you probably won't be working in the same place. It is also difficult for someone managing other people's money to take an independent line. To be wrong when everyone else is wrong is not such a terrible thing: You may lose a bonus, but probably not your job. On the other hand, to be wrong when everyone else is right... So everyone focuses on the same short-term numbers, tries to ride the trends, and buys the silly economic theory du jour.

Listening to all that money talking made me very nervous. After all, these people can funnel money into a country's markets, then abruptly pull that money out--and create a boom-bust cycle of pretty spectacular proportions. I don't think they can do it to the U.S.--in Greenspan I trust--but I am not 100% sure.

One thing that I am sure of is that the Asian leaders who have been fulminating against the evil machinations of speculators have it wrong. What I saw in that room was not a predatory pack of speculative wolves: It was an extremely dangerous flock of financial sheep.

PAUL KRUGMAN is a professor of [economics](#) at the Massachusetts Institute of Technology.

Copyright © 1997, Time Inc., all rights reserved.

You may now print or save this document.

Portions of above Copyright © 1997-2000, Northern Light Technology Inc. All rights reserved.