Market Dynamics

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Performance Management System

Hidden Information And The Stock Market

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

Wall Street has its share of lemons, just like the used car market!

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I recently started a new book and, as is my wont, I skipped ahead to a chapter that looked interesting. The new book is by John Cassidy and the title is *How Markets Fail—The Logic Of Economic Calamities.* The chapter that caught my eye was about "hidden information" and it relied on the work of the Nobel prize winner in economics, George Akerlof.

Akerlof won the Nobel Prize for his paper about how the market for used cars worked. This was not about economic equilibrium but about how one side of the transaction had an advantage over the other. An information advantage. The paper was published in 1970 as "The Market For Lemons: Quality Uncertainty and the Market Mechanism" and it was initially rejected by several prestigious academic economic journals. It later became one of the most frequently referenced articles in the economic literature.

The article addressed the issue that the seller of a used car had a superior information advantage over a prospective buyer, since he knew first hand from experience, about the quality of the vehicle, its reliability and its probable value. Akerlof called this advantage "hidden information."

Other economists have written extensively about hidden information in other markets such as health insurance and finance. It seems clear that these markets are not efficient and that hidden information is an essential feature of those markets and how they work.

Since I am primarily interested in the financial markets, this seemed worthy of comment. I have long believed that the stock market is not efficient and that hidden information exists. I had never heard the term hidden information in that context before but it sure rang a bell.

Akerlof indicated that financial intermediares made their profits as a result of hidden information. Commercial banks, investment banks, hedge funds and money managers need hidden information and they go to great lengths to develop it. They are in the business of producing hidden information. Even the financial media make a business out of hidden information.

Many of the institutional investors that I work with benefit from private meetings with the managements of the stocks they own. This information is not public and it provides an edge to those institutions. This qualifies as hidden information. It may not constitute insider information in a legal sense, but it is very useful to those investors. Another form of hidden information has been revealed in the media recently regarding the "huddles" at Goldman Sachs between analysts, traders and the institutional sales staff. I don't know why the WSJ is making such a big deal about it, it has been going on for years. But it does represent hidden information and it is not shared equally among all the clients of GS. There is nothing illegal about this practice, as far as I know, but it does constitute hidden information.

The stock market is not efficient but it is driven by hidden information. The need for hidden information produces the widespread information networks that regularly form between individuals, sales people and trading desks on Wall Street. It is completely naïve for individual investors to believe that these networks don't deal in hidden information.

Caveat Emptor.

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