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Investors and Efficient Markets: The Everyday Imaginaries of Investment Management

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While bond markets have long been an important site where governments have looked for funds, in the last two decades the issuing of stocks and bonds has become a major source of credit for companies in rich countries. The recent financial crisis has highlighted for the latter what had become obvious for poorer ones with the crises of the last ten and fifteen years, i.e. that the major role of financial corporations in distributing credit has a political content, since it affects the general distribution of resources and the inequalities and growth prospects that go with it. This paper will present some of the imaginaries that organize the everyday practice of investment management, a major practice through which these corporations distribute money around the world. In particular, I will explore the presentations according to which the distribution of credit is the deed of “investors” who channel money through “markets” that are more or less “efficient”. I will concentrate on investment management, due to its major role in the distribution of credit, but what I say could be explored in other professional tasks (for traders, see for instance Zaloom, 2006, for regulators, see Maurer, 2004).

The presentation of events in financial markets by the mass media usually speaks of price movements as the deed of “investors” with “expectations”, “sentiments” and “calculations”, who “factor in” information, be it interest rates, inflation and unemployment rates, and so on, and “value” accordingly their objects of investments. The regulation of financial practice, on the other hand, often aims at “protecting the investor” by establishing rules that are hoped to ensure the reliability and the “transparency” of transactions, in a way that should allow markets to be “efficient”. The concept of “efficiency” here is often understood in a double sense, that is linked to its formalization in political and economic theory for more than a century: markets are “efficient” if they allow investors to integrate all available information in the price of the asset; by the same token, they allow for the optimal distribution of resources, as prices give the signal of the opportunity to direct investment in one direction or another.

This paper is based on fieldwork research carried through participant observation as an intern with stockbrokers, fund managers and hedge fund consultants in Paris and New York between 2002 and 2004. The three four-to-five months internships were completed with around a hundred interviews with professionals in Paris, London and New York, some of whom I had worked with, and with an extensive analysis of manuals of financial analysis and portfolio management. I would like to show that the presentation of investment management as the deed of “investors” within “efficient markets” is not just an external idealized view that bears little relation to what practitioners really do. At the same time, it is also not an adequate presentation of their activity, contrary to the assumptions often made within financial theory. Several studies have shown that the assumptions of the “efficient market hypothesis”, fundamental in financial theory, are important in the formulas and calculation techniques used by financial professionals (Muniesa, 2000, 2007; MacKenzie, 2006). Other studies have analyzed how employees of the financial industry indeed engage in maximizing practices for their personal interest within their labor relations (Godechot, 2007). The point here is not to say whether there is “economic rationality” or not in professional financial practice but to analyze how this practice is organized by certain imaginaries of financial agency, that define not only cognitive tools, but also everyday procedures, organizational rules and the multiple but limited strategies and justifications that are possible within them. I will first recall certain major features of the financial imaginaries of the “investor” and of “efficient markets” in order to analyze how they play a major role in investment management today.

The theoretical definition of a financial agency as that of an investor in efficient markets

The formulas that can be found in financial analysis and investment manuals invariably imply a specific gaze from which the formula is defined and is supposed to be ap-
plied: that of an “investor” whose sole aim is to maximize returns on his capital. In order to do this, the investor has three main ways to define the value of the object in which he will invest. The first considers that the object has an “intrinsic” or “fundamental” value, which is generally defined by the absolute return that it is expected to provide to the investors, such as dividends, capital gains, coupon, etc., however calculated (usually discounting expected future revenues). The second considers this same capacity of the object to generate revenue but only as compared to other objects. The value of the asset is then “relative”\(^2\). Finally, the object can also be considered through its “market” value, defined by the price at which it could be bought or sold at a particular moment and place, whether in regulated or over-the-counter transactions, which means that there is not always “one” price at the same time\(^4\).

While fundamental value is supposed to be defined solely by the relation between the investor and the object of investment, in concrete practice, it generally mobilizes categories that define the object in a generic way and inscribe it already in a relative valuation. Relative valuation, in turn, is based on the logics of fundamental valuation, but transcends it in a way that renders insufficient the self-standing status of the object of investment. Finally, market value can be considered as the erratic result of the encounter of supply and demand at any instant, but its rationales are often related to fundamental and relative valuation (Tadjeddine, 2000).

The calculations of each generally take into account data that is produced by mobilizing the logics of the other two (market prices, statistic comparisons between assets, ratings, etc.). Thus, there can be tensions and even contradictory rationales and results for the same “investor” when the formulas are mobilized and value is defined\(^5\).

The definition of value is conceived in order to orient investment. The ways in which this is supposed to be done generally assume at certain levels that markets are “efficient”, i.e. that prices reflect all available information. This price is considered to reflect what the best fundamental valuation could achieve. The equilibrium of efficiency is thus considered to reconcile the valuations of the individual and the group. From these assumptions, financial theory has developed the idea that since the prices reflect all information, the investor should not try to bet against the market, but on the contrary buy the whole market and hold it, in order to dilute the uncontrollable volatility of each asset, and to be exposed only to “market risk”\(^6\). Applied consistently, this investment rationale enters into a peculiar conflict with that of the existence of an “investor”. The hypothesis of “efficient markets” implies that there are constantly investors looking for information in order to reflect it in their bids and offers. But when the price is the result of all these individual actions and no more information can be found, it at once reflects the “true” value of the object of investment and dislodges the need for there to be investors trying to find a better price. Thus, if markets are considered to be efficient at any particular point in time, it is superfluous for any “investor” to try to value assets “better” than the market: the price reflects the true value. To take one example among many, this tension appears very clearly in a very respected and mainstream French manual of investment management, whose introduction starts with the following statement: “Financial theory indicates that in an efficient market – and there are numerous proofs that all big financial markets in the world come close to this characteristic – the totality of the available information concerning securities, the market, the economy, etc. are reflected very quickly in the price. Thus, in general, the price of an asset is very close to its intrinsic or “true” value” (Jacquillat & Solnik, 2002: 1). After several chapters exploring the methods to calculate value in different ways from the point of view of an “investor”, the authors reach the point in which the hypothesis of efficient markets is applied to determine the investment strategy. They then negate the need for the investor to do any valuation: “In the absence of privileged information, no investment should be specifically preferred. The asset portfolio must be as diversified as possible. […] The strategy of investment is essentially passive, in the sense that it is useless to turn over the portfolio looking for assets that would be under or over valued. This conclusion explains partly the development of indexed funds and ETFs (Exchange Traded Funds), the sole aim of which is to replicate the performance of the market index. It is regularly observed that professional fund managers and mutual funds find it very hard to beat the market. […] The logical implication is to base the investment strategy in indexed funds, which have no specific risk and minimize transaction costs” (Jacquillat & Solnik, 2002: 133, a similar assertion can be found in Gitman & Joehnk, 2008: 379-380).

This tension does not concern one manual or a minor set of formulas. It is actually present in several formulas to calculate discount rates, or to price options and futures. The hypothesis of “efficient markets” is often mobilized at different points of these formulas, to define certain values that are needed to apply them. More crucially, the theoretical price that many formulas give is defined from the theo-
retical perspective according to which the market efficiency renders arbitrage impossible ("the principle of ‘no arbitrage opportunity’") (3). The tension between the figure of an “investor” and “efficient markets” can appear to be eased by a specific temporality, in which “investors” are needed for individual valuation as long as “market efficiency” is not reached, and they can be discarded once the price reflecting the “true” value has been obtained. This would imply a certain (actually inexistent) criteria to detect in which of the two states actors are operating. But the tension is actually much stronger, since it is embedded in the formulas themselves, and in the everyday practice of financial professionals, which stand in the contradiction of having to assume that both states happen at the same time. I will explore this latter point by describing some major everyday rules of practice of investment management and the tensions and controversies that organize the positions of the people who apply them.

The figure of the investor, efficient markets and the organization of investment management

The ambiguities of the figure of the investor

The figure of the “investor” with its multiple and conflicting definitions of value is present in a crucial set of procedures that the employees of investment management firms must apply in order to keep their jobs and, hopefully, increase their income through the bonus system. Financial analysts often tend to speak of their personal “beliefs”, “convictions” and of the “authenticity” of the valuations that they publish for their colleagues and clients. Fund managers often talk about feeling a “bodily pain” when prices go down, stressing the personal link with “their” funds, i.e. the funds their clients have entrusted them. But the personalization of the application of the procedures that are supposed to enact the actions of an “investor” is not just a discursive tool accompanying practices to which it would be unrelated. The inequality of bonuses between employees of a same rank within a same team, generally justified by their different inputs into the generation of profit, is only one example of the idea that each employee can act individually in valuation and investment decisions. The relation between fund managers and brokers, for instance, is generally organized as the encounter of “personalities” with particular interests, defined as ways to value assets, but also as specific activities (going to the opera, hunting, etc.) that they can share in order to better know each other and perform a better valuation (Ortiz, 2005). In spite of all the standardized calculation techniques and risk measurement procedures, the fact that value cannot be given a single price that is immediately accepted by all actors is generally presented as the fact that valuation and investment decisions are an intrinsically “personal” matter, to be performed by experts who are then “investors”.

The conflicts between approaches to value within the professions, for instance between financial analysts oriented toward fundamental valuation, traders oriented towards market valuation and fund managers mobilizing the efficient market hypothesis, happen within a same company, and can lead to open and even heated discussions between employees. The positions of each employee can also be indifferent or even cynical, some enacting the figure of the “investor” with more pleasure than others. Charles Smith’s typology of market professionals (Smith, 1999) describes a vast array of these positions. He nevertheless seems to take the importance of the personal input for granted, without analyzing in depth how much it is actually explicitly organized and imposed on actors by the procedures that they have to follow, something that the latter often describe in a detailed manner in the intimacy of interviews and casual conversations.

The fact that employees can have very different relations to the way in which they act as “investors” is all the more problematic, since employees only enact this figure for the sake of someone else, as they are generally not the owners of the capital being invested. In the US, most fund managers are linked to the owners of the funds by the trustee legal relationship, in which they are supposed to best represent the interests of those who would then be the “real” investors. The paradox is even stronger in this case, since the “real” investors are legally prevented from having a say in the way in which value is defined and money invested, their only “personal” input being that of withdrawing from the trustee relation and reproducing it with another provider of financial services (Clark, 2000; Montagne, 2006).

The tensions between the investor and the efficient markets

Mainstream investment management is organized within two explicit poles that are defined by the opposition between the individual “investor” and the hypothesis of “efficient markets”: one assumes that markets are not efficient and the other that they are constantly so.
The first position is often presented as a justification for the activities of hedge funds. This is often true in their advertising, in the discourses of their managers, but also in the controversies concerning the regulation of hedge funds. Hedge fund managers can either be presented as enhancing market efficiency by exploiting arbitrage possibilities and eventually making them disappear, or as disrupting market efficiency by manipulating what would otherwise be a “normal” volatility of price adjustment. In either case, most hedge fund investment strategies put the fund manager at the center of the valuation and investment decision process, and include the idea that there are possibilities to “beat the market” or other mainstream fund managers by developing an individualized approach to the value of tradable assets.

At the other extreme stand indexed funds, which can be managed by software that replicates a specific index. As explained by the authors quoted above, indexed funds take to the extreme the developments in financial theory assuming the hypothesis of “efficient markets”. These tend to imply that investors should diversify investments within the whole market in order to reduce volatility, negating the usefulness of having a specific employee doing the analysis of single assets and making convinced bets based on beliefs and personal valuation. In many interviews and marketing material, hedge fund managers insisted that investment management should be left to indexed funds, which have low costs, and to hedge funds, where the personal added value of the manager, much better paid than mainstream managers, could be maximized.

Indexed funds and hedge funds constitute the two extreme poles between which the mainstream management approach is situated, often presented as a “mix” of the two. It consists on fund managers being given an index on which to invest and to which they are compared. They are then expected to perform “better than the benchmark” by a small margin. Their investment universe is thus limited in advance, as well as their performance target. But they still have some space for personal valuation, as they can slightly play with the weights of each stock in the fund, giving bigger weights to the assets whose performance they expect to be better, and smaller weights to those that are expected to “underperform”. Usually the performance target is defined as a spread of one or two percent to the performance of the index. Thus, if the index’s performance is 18%, 2% or -16%, the fund’s performance must respectively be 20%, 4% or -14%. While the input of the manager may be considerable when the volatility is low, it is of less value when prices changes are strong. Also, trading profits may be higher than the spread achieved by the manager, which actually tends to give an increased weight to trading desks in fund management companies (Ortiz 2005, 2008).

The opposition highlighted in the manual quoted above is thus not only a conceptual peculiarity. It contributes to define and regulate the positions and oppositions of employees sometimes within a same company. In 2003, in Acme, a major French multinational of investment management in which I worked as an intern with fund managers investing in asset backed securities, the investment in European equities was organized, in a classical fashion at the time, with a “core” investment fund, concentrating around ten of the eleven billion euros managed by the team of eight fund managers and six analysts. The “core” was split between the managers, but they all replicated an index and tried to “beat it” by a “few basis points”, according to a strategy decided in regular meetings by the senior fund managers and Yves, the head of the team. The latter explained to me in an interview that in order not to “kill the creativity” of his employees, they also had the possibility to manage ten percent of the money in a more “personal” way (these funds are called “satellites”). Paul, one of the fund managers, explained to me in an interview that he invested 90 million euros in the same index as the “core” fund, but with different weights and hedging his position with futures contracts. He explained that the results of the two strategies could be of course be very different, and that he could happen to make opposite bets on each of them. He considered that at times, especially when his personal strategy was more successful, this was “frustrating”, but that he had “no choice” when it came to follow the “core” strategy. Yves remarked that he had made it clear to all fund managers that their bonus depended on the performance of the “core” fund, so that they would “understand where their interests rest”.

The hazy temporal horizon of market efficiency

The research in Acme was carried in 2003, and most employees took some explicit position towards the explosion of the Internet bubble. Fernand, the head of the Allocation department at the time, who oversaw the crucial distribution of funds among assets, which in turn had a direct impact on the fees collected by each team, and therefore on bonuses, developed a classical interpretation of events along the lines of market efficiency. He considered that the Internet bubble confirmed that “markets exaggerate all the time”, but that they are “right in the long run”, since the
new information economy was indeed a major force of growth. This type of argument, often developed during the crises of the last fifteen years (Russia, LTCM, South-East Asia, Argentina...), implies the temporal succession described above, according to which “investors” search for information and once that they have integrated it, after the bubble, manage to give a fair valuation of the assets. Fernand considered that this justified maintaining his long-standing and classical strategy of investing in equities and bonds with the “mix” approach. He was replaced during my fieldwork by Nicole, who headed the Structured department, where I was employed, and which concentrated hedge funds, financial derivatives and indexed funds. Her position was that not only were markets not efficient, but that fundamental valuation was helpless against the erratic character of their movements. For her, the Internet bubble signaled the end of the “passive” strategy, and the need to match market volatility with derivatives, her long-standing field of expertise. The capacity of “investors” to develop relative valuation would be the solution to the inefficiency of markets. The change at the head of the Allocation department meant a progressive increase in the flow of funds to these activities, while more classical approaches to investment would thus have reduced opportunities to charge fees and bonuses.

The change in power at Acme had to do with a bitter struggle for funds, fees and bonuses and the prestige of directing the investment strategy of the company. It was also linked to a generational gap, since Nicole was nine years younger than Fernand. The latter had only had a university degree in economics and had started his career doing fundamental valuation of stocks. Nicole had a postgraduate degree in statistics and had started working with financial derivatives in the eighties. But part of these struggles was organized along the controversy concerning the relation between the “investor” and “markets” deemed to be “efficient” in a hazy time horizon. The impossibility to determine consensual criteria to declare a market “efficient” at a particular time actually allowed for this controversy to be structured and to legitimize the changes in power and in the strategy of the company.

Investment management is only partly organized by the financial imaginaries such as the concept of an “investor” with his several definitions of value, and that of “efficient markets”. But these imaginaries do not define only cognitive landscapes. More generally, they also frame sets of possibilities within which the actors develop different strategies in order to position themselves in relation to their own work, and in relation to each other in what can often be a bitter struggle for fees, bonuses and prestige. This poses methodological questions for the way in which those imaginaries are treated by the social scientists that study them, and for the role that they play in the political legitimacy of their use within contemporary finance. I will briefly turn to these points in order to conclude.

The political imaginaries of the global distribution of credit by contemporary finance

In this paper I have not analyzed such basic concepts of financial theory and even of economic theory as the figure of a maximizing independent “investor” and the hypothesis of “efficient markets” in their own theoretical terms or as mere cognitive tools for market practitioners. I have approached them as imaginaries, i.e. narratives, rationales and rules of action that organize the bureaucratic procedures of investment management, mapping and also limiting the possibilities of action of the employees who apply them. This means taking seriously the conceptual frames and the tensions and contradictions they carry with them in order to understand everyday practice. This is not due to the fact that by themselves these concepts would tell us something about investment management, but to the fact that professional financial practice and academic financial theory have been influencing each other for decades, and that such concepts do play important roles in the definition, organization and justification of professional tasks.

The analysis also sheds a light on the complex legitimizing role of these concepts. Fund managers, financial analysts, traders, asset allocators and other employees can quite consistently consider, and claim, that they are “investors”, in that they indeed apply the gaze and the rationales of a figure that is defined in the procedures, i.e. in the types of analyses, calculations, and commercial and legal relationships in which they have to engage according their labor contracts. Financial professionals, those who describe them, such as the media, and those who regulate them, have various interactions with each other, and often share similar educational backgrounds in financial theory. They also often share the same assumption according to which the legitimate controversy that they have to deal with concerns the fact that the activity of the “investors” indeed ensues in “efficient markets”. The tensions and conflicts that arise between these concepts in the everyday practice in the financial industry are not experienced as unacceptable con-
tradictions, but as dynamic tensions whose resolution, even if it remains ideal, must be thought as possible 10.

This does not explain away the importance of vested interests and major strategies in the defense of the current financial system, but it does allow to make a link between the everyday practice of financial professionals and its justification in the terms of a set of "efficient markets" in which "investors" define value and allocate credit in a way that, if it is not perfect, remains the closest to what would be socially optimal. The regulatory reaction to the current crisis, concentrated on enhancing transparency and a better valuation of risks, i.e. a better enacting of the logics of the investor, remains within this imaginary. The social sciences can address the importance of these concepts, of their possibilities, limits and contradictions, without falling into the trap of having to position themselves for or against them, but by analyzing how they work in the everyday practice of those who use them. Asking how they are really applied, in quite a Weberian fashion, allows for seeing the distance between their use and the utopias in which they were created (Weber, 1949 (1904)). This does not give an answer to the question of their political legitimacy, but at least it opens yet another door for the question to be asked.

Horacio Ortiz, anthropologist and philosopher, has recently got his PhD in Social Anthropology from the Ecole des Hautes Etudes en Sciences Sociales (Paris, France). He is interested in the role played by financial markets in the distribution of resources and money.

Endnotes

1In another context, I would use the feminine pronoun to speak of abstract actors, if only to remind of the gender biases that language may impose on our reading. Here, nevertheless, this would have the misleading effect of erasing the fact that most people in positions of responsibility in the financial industry are male. I will therefore use the masculine pronoun when speaking of abstract actors.

2Sometimes, when the fundamental value is difficult to define, relative valuation can become the main source to define value, (cf. Beunza & Garud, 2006).

3Over-the-counter (OTC) transactions are carried out within a network of exchange with no visibility of the whole, where each transaction is negotiated on a one-to-one basis. They are extremely important, for instance for credit derivatives or spot and forward currency transactions.

4These basic concepts appear in any manual of financial analysis, see for instance (Gitman & Joehnk, 2008).

5I have analyzed this in detail for stocks and asset backed securities in (Ortiz, 2008).

6These developments are legitimized by the Nobel prizes won by the academics considered to be their authors. Harry Markowitz won the Nobel prize for the Modern Portfolio Theory, while the Capital Asset Pricing Model was developed by John Lintner and William F. Sharpe, the latter being later awarded the Nobel prize for his work on option pricing. For a history of these developments, see (Walter, 1996), (Bernstein, 1998) and (MacKenzie, 2006).

7See for instance (AZEK/ILPIP 2008: Ch. 3, p. 8)

8These assertions come from the twenty interviews carried with alternative investment professionals, and the analysis of hundreds of pages of advertising by hedge funds, on line and in marketing documents (Ortiz, 2008: 498-538).

9The issue of short selling, often assumed as possible in market efficiency models, highlights a tension within the definition of the “investor”, which is at times considered to be completely detachable from the interests of the company in which he invests, and at times considered to be obliged to hope that the price of the stock would uniquely follow an upward trend.

10Foucault has analyzed the importance of neo-Kantian idealism in 20th century ordo-liberalism and the way in which “market efficiency” is considered to be an “ideal” (Foucault, 2004)

References


