Cliff's Perspective

Efficient Inefficiency: The Oxymoron That Explains the Investing World

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In writing the foreword to a very good book by Antti Ilmanen (before he joined our firm) I mentioned that I had two options: I could kill Antti to prevent him giving so much good stuff away, or I could praise his book. I chose to praise. Now another outstanding Nordic researcher (and AQR partner), Lasse Heje Pedersen, presents me with the same dilemma: His new book, *Efficiently Inefficient* (Princeton University Press), is fantastic — almost too good at laying out how successful professional asset managers think and act. Lasse is Danish, Antti is Finnish. I'm not saying there's a connection. But I'm not saying there isn't, either. Anyway, I have decided to continue my policy of nonviolence and hope I don't regret it. We actually have one other Danish partner; if he writes a similarly too-good-reveal-too-much book, all bets are off…

For me, a good book is one that speaks to something important and that causes me to think differently and more clearly about the chosen topic. Lasse has written just such a book.

Although perhaps at first glance the phrase "efficiently inefficient" may seem paradoxical, even tortured, it is anything but. Upon diving into the book, the essence of the title (and the book) crystallize. The phrase "efficiently inefficient" combines the notion of efficient markets — the idea that prices reflect all relevant information at all times — with its opposite, inefficient markets — the idea that market prices are significantly influenced by investor irrationality and market frictions. When fused together, "efficiently inefficient" arrives at the idea that perhaps markets are, on average (it's always about averages, exceptions will always abound) just inefficient enough to compensate managers and investors for their costs and risks, but not more inefficient than that. Furthermore, this isn't just a random fortuitous occurrence but the one we should've expected from the get-go. Efficiently inefficient is the real world, it is the one in which investors live day to day. A world where competition within the investment profession results in markets that are almost efficient, but certain inefficiencies exist that may reward those for selectively taking risk and absorbing the associated costs of doing so. Lasse gives us a unique framework for understanding, and effectively navigating, such a world.

He tackles this daunting task with a two-pronged approach. He first identifies and explains a roster of economically intuitive, historically effective, practically relevant investment strategies. He then brings these classic strategies to life through interviews with sophisticated pioneers (full disclosure, I am one of his less-sophisticated subjects) who have successfully developed and implemented those approaches. Equally impressive is the range of strategies illuminated— equities (fundamental, short-biased and quantitative), global macro, managed futures and arbitrage (fixed income, convertibles and event-driven). And so, as a good book must do, Lasse brings great clarity to these active approaches; the economic basis and rationale for their existence as well as the specific return drivers behind them that facilitates harvesting the excess returns. The backdrop throughout is a market environment with efficiently inefficient prices.

Lasse gives specific examples where the tools of empirical finance (also described in the book) can be applied in a variety of settings. A particularly fun application for me is when Lasse turns his attention to Warren Buffett. The question of how Buffett has performed so magnificently for so long is a perennial mystery. The book discusses how Buffett's returns can be explained (explained, not minimized; by no means does Lasse imply becoming one of the world's richest men is easy!) by his preference for cheap, safe, high-quality stocks combined with a persistent use of modest leverage (also the subject of a paper, "Buffett's Alpha," written by Lasse and AQR coauthors). Readers will undoubtedly be inspired to research and uncover their own favorite applications for the techniques described.

From now on, there are two kinds of investors: the efficiently inefficient ones and the merely inefficient ones who didn't read this book.

Darn, that would've been a great blurb for the dust cover!

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