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Where Markets Fail: An Imperfect Discounting Mechanism

By Jason Voss, CFA
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I am an avid fan of capitalism as well as a critic.

While I agree that markets are generally better at discounting the future than individuals, there are inherent flaws in the markets that are difficult, if not impossible, to overcome. I point out these weaknesses because, just like with any mental model and organizing principle, knowing the weaknesses is the first step in avoiding or discounting them.

Imperfect Discounting Mechanisms

Many capitalists believe the markets are sacrosanct and, in their blind devotion, prove why “pure” is the root of puritanical. They cite aphorisms like “the wisdom of the crowd” or the improved predictions that come from crowdsourcing. I accept, acknowledge, and even revere the truth in these observations. After all, markets derive prices by aggregating differing expectations of the future.

But even the agglomeration of crowd opinion cannot overcome an inconvenient fact: time. That is, time marches in only one direction — forward. Effects follow causes. To the degree that causes are repeated, probable effects can be charted.

But the future is capricious. That is why we turn to markets in the first place. Were the future predictable, there would be no reason to aggregate differing views of supply and demand for goods and establish market clearing prices. Only The Price Preeminent would exist — an omniscient price that represents the market clearing price not just for current supply and demand, but for all time.

For example, if we knew in the late 1800s what we now know about the effect of hydrocarbons on the environment, they would have been priced higher. Alternatively, what if we could peer into the future and see the complete trajectory of human existence? And suppose, in that perfectly transparent timeline, we could see that potable water would eventually become scarce enough to result in the end of people? Obviously the signal from this All-Knowing Market would be very different.

But people are not seers. Yes, markets adjust to new information to balance supply and demand, but given our inability to predict the future, many goods and services are currently mispriced — perhaps dangerously so.

There are plenty of examples of markets doing a poor job of discounting.

A number of Samsung's infamous Galaxy Note 7 phones spontaneously burst into flames causing much mayhem. You could argue that this is not a failure of the markets. But it is. After all, there was a market for these phones. Samsung eagerly supplied them and buyers eagerly purchased them. Once the fire hazard became known and the replacements failed to rectify the problem, the market disappeared. This illustrates both the power of markets and their primary weakness. Yes, the phones are no longer for sale since the entire market for them vanished, but signatories to the market for the Galaxy Note 7, both supplier and demander, failed to see far enough into the future to prevent catastrophe.

Another example is the side effects of prescription drugs that are not fully appreciated until many years into the drugs' use. This despite the extreme level of scrutiny on the front-end of drug development.

Possible Remedies

- Perhaps new products could be evaluated by their closeness to the natural world. For example, timber directly effects nature, consulting not so much. A proximity-to-nature continuum could also serve as a resiliency-monitoring tool. The closer to nature, the greater the need for systems thinking, scenario planning, and caution. This is not an argument for stifling regulation or for you to run out and hug a tree. I am saying that even when armed with market-cleared prices, people can screw things up. This means that any new product directly affecting the environment ought to be overpriced initially. This margin of safety could be put into a profit escrow account, assuming that the market still clears at the new price.
- Alternatively, as products are designed, they should have a built-in plan for the lifecycle of their components as well as contingency programs for how any

potentially deleterious effects may be unwound. That is, what is the estate planning for a new product? How do you "put it to bed?"

- Perhaps a new product checklist should be developed, all the components of which must be addressed before a license to market is granted. A variation of the US Bureau of Consumer Protection could be the adjudicating body.

This article is the first in the five-part Where Markets Fail series. Subsequent entries will consider how markets:

- assume a context;
- assume fungibility;
- are not systemic; and,
- have "visible hands."

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About the Author(s)

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Jason Voss, CFA, tirelessly focuses on improving the ability of investors to better serve end clients. He is the author of the Foreword Reviews Business Book of the Year Finalist, *The Intuitive Investor* and the CEO of Active Investment Management (AIM) Consulting. Previously, he was a portfolio manager at Davis Selected Advisers, L.P., where he co-managed the Davis Appreciation and Income Fund to noteworthy returns. Voss holds a BA in economics and an MBA in finance and accounting from the University of Colorado.

Ethics Statement

My statement of ethics is very simple, really: I treat others as I would like to be treated. In my opinion, all systems of ethics distill to this simple statement. If you believe I have deviated from this standard, I would love to hear from you: jason@jasonapollovoss.com