[Enterprising Investor](#)
Practical analysis for investment professionals
24 July 2017

Where Markets Fail: Visible Hands

By Jason Voss, CFA

Posted In: Drivers of Value, Economics, Equity Investments, Fixed Income, Investment Topics, Philosophy, Portfolio Management, Risk Management

Markets are less perfect than commonly assumed.

I have discussed their inability to price unknowns; the blindness of the assumptions that underlie market activity; that the implicit presumption that market fungibility bears consequences; and that markets are not systemic.

How else do markets fail? They have visible hands, not invisible ones. Markets rely on symmetries between sellers and buyers, but due to these interventions — visible hands — those symmetries do not exist.

Market information is asymmetric.

Tobacco companies hid evidence of the cancerous nature of their products because they knew disclosure would forever shift the demand curve left. General Electric (GE) delayed its massive clean-up of the Hudson River for similar reasons. When you buy something from a secondary market — including eBay or antique stores — you seek to benefit from knowing more about the product than the seller. In our own industry, hucksters often obfuscate the costs of financial products.

These examples demonstrate an asymmetry of information between buyers and sellers. Which is ironic because markets are supposed to be about more than just the exchange of goods and services. Aren't they also about information discovery? Specifically, the invisible hand that is price discovery? In fact, hiding information from one or both parties is a way to facilitate market transactions. That is, it is doubtful that both sellers and buyers are transacting exactly where marginal benefits equal marginal costs. Both likely perceive marginal benefits that are greater than or equal to marginal costs and some degree of economic surplus in the transaction.

Sellers think they are selling at maximum marginal profitability and buyers think they are buying marginal utility, right? If you think about it, this requires that some information be hidden from both parties. Sellers know exactly how much it costs them to manufacture or inventory an item as well as their required or even actual profit margins. Buyers know their true income, their ability to pay for a good, and just how much they want that good. In general, this mechanism — markets — facilitates beneficial economic activity. Yet the price changes if either party gets wind of the position of the other.

Thus, contrary to their general perception, markets have incentives to hide rather than to reveal information. These incentives, which spur actions, are visible hands.

Benefits are asymmetric.

Another asymmetry represents the tug-of-war between buyers and sellers: The different benefits of engaging in a transaction. On one side, most goods and services have tremendous consumer surplus embedded within the market clearing price.

What is consumer surplus? Imagine you don't own any shoes and have to rent a pair each day before heading out the door. How much money would you pay to wear shoes today? Most people say something like £5, $10, or ¥2,000.

Yet, if you multiply that by the number of days each year you want to wear shoes, say 300, you get a price of approximately $3,000 per pair. Clearly, most consumers do not pay anywhere near that figure. The consumer surplus represents the difference between what you would pay and what you do pay.

Conversely, supplier surplus occurs when you pay £10 to see a movie and wish you hadn't. Bundling is another form of supplier surplus. iTunes eclipsed compact discs (CDs) in part because most people only wanted one or two songs from an album, but record companies made

you buy the whole CD. If you wanted to read the sports section, you had to buy the entire newspaper. Few people read the whole paper, but that's what they paid for.

Markets are not systemic either, and often their real costs are not reflected in their prices. Supplier surplus accrues here as well. For example, human capital is not capitalized, yet the returns on people are booked as operating income. Practically speaking, if a grocery store has 1% operating margins, but the wear and tear on its people are not capitalized and expensed, then in all likelihood, the store is operating at a loss. The difference is an asymmetry that is not priced in and represents a conscious, visible hand interfering in markets.

You may think this is no big deal, but markets are supposed to deliver accurate pricing so that resources are allocated efficiently on the front end.

Timing is frequently asymmetric.

Timing is an obvious and critical asymmetry. Think, "Act now, while supplies last!" or "Special one-time offer!" You may believe these pitches, which everyone receives at one time or another, are just capitalist treacle. But such techniques work. How do I know? Because they are still used. Sellers and buyers both may have all the time in the world, but sellers show the visible hand by creating the perception of rapidly increasing scarcity in the face of your demand. Still, this is harmless . . . right?

When I was an investment manager during the dot-com era, new multi-billion dollar securities issues were scheduled to come to market in less than a day. A red herring would be emailed out about an hour before the close of the market. If you were lucky, there would be a conference call with management or a sell-side analyst just after the close. You then had to place your bid on the offering. "Act now, while supplies last!" These timing games mean that capital is allocated inefficiently and represent another visible hand in markets.

More Visible Hands

- Regulations
- Lobbying (in markets as well as in politics)
- Anything meant to obscure the true nature of a transaction, including bribery, graft, nepotism, etc.
- Monopoly, monopsony, and oligopoly
- Explicit or implicit price fixing

Possible Remedies

- Ask what information the counterparty may have in a prospective transaction that you don't. Management may know the cost of its incentives programs relative to all other shareholders. Are you blindly voting the proxy not knowing this information? Management is counting on it.
- Before transacting, are you sure you understand the value of a good or service to you? What information is out there to which you don't have

access? Are labor-intensive and low-margin businesses you invest in actually earning returns on capital?
- What are the unspoken components — the elephants in the room — that overshadow or underlie a transaction?
- Do you have enough time to render impartial, independent, and full judgment? If not, insist upon it, or else pass on the transaction.

If you liked this post, don't forget to subscribe to the *Enterprising Investor*.

All posts are the opinion of the author. As such, they should not be construed as investment advice, nor do the opinions expressed necessarily reflect the views of CFA Institute or the author's employer.

Image credit: ©Getty Images/erhui1979