
# Three Ways to Profit from Stock Market Inefficiency

It is our belief that investors can profit from stock market inefficiency. That is to say, there are stocks that are not accurately priced given a full and accurate assessment. The view that you can profit from stock market inefficiency is at odds with the concept of an efficient stock market. According to *Investopedia*, the **efficient market hypothesis** has it that

*- it is impossible to "beat the market" because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. According to the EMH, stocks always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices.*

The problem with this point of view is that famous investors like George Soros and Warren Buffet make a lot of money by purchasing underpriced stocks which subsequently rise in price. Sometimes this requires a change in business plan and sometimes it simply has to do with sound fundamental analysis of investment opportunities. A good example of stock market inefficiency is any given small cap stock that is not followed by the market at large. If such a stock were to be watched closely market analysts might see reason to rate the stock a *buy* but if no one is watching, only those who are paying attention will buy early and make money when the stock price rises. This is the definition of an inefficient market.

### An Inefficient (Market) Definition

As noted in the financial *Free Dictionary*, in an **inefficient market**

*- investors may not have enough information about the securities in that market to make informed decisions about what to buy or the price to pay. Markets in emerging nations may be inefficient, since securities laws may not require issuing companies to disclose relevant information. In addition, few analysts follow the securities being traded there. Similarly, there can be inefficient markets for stocks in new companies, particularly for new companies in new industries that aren't widely analyzed. An inefficient market is the opposite of an efficient one, where enormous amounts of information are available for investors who choose to use it.*

### Three Ways to Profit from Stock Market Inefficiency

Stocks end up being priced inaccurately because investors do not understand the business plan, intrinsic value and margin of safety of a company.

- The first and foremost of our three ways to profit from stock market inefficiency is to learn how a company makes its money, that this method will keep working in the future and what assets it has to protect against temporary misfortune.

- The second of our three ways to profit from stock market inefficiency is to be on the lookout for new stocks and to thoroughly analyze them. No one can follow every stock in the market all of the time. When you find an under-analyzed and therefore underpriced stock you may be able to profit a hundred fold or more.
- And our third way to profit from stock market inefficiency is to think outside of the box. When the retailer, Sears, fell apart years ago it merged with Kmart and was not making a lot of money. But, the company has a huge amount of property and the stock price went up from $15 a share to $150 a share over the next two years as investors realized the value and margin of safety of the stock.

**A Footnote**

There are other examples such as an article in *Better Investing*, **The Inefficiency of the Efficient Market Theory**, which states that

*- If markets were truly efficient, they should never have price bubbles. In 2008, when prices tumbled, many well-managed companies lost value in their stock because of fear and panic. There was no efficiency in the bubble or in the resulting selloff. Even so, the many obvious bargain stocks remained low because everyone was afraid. How low would the market go? An "efficient" market would have been rational. Stock prices would have fallen only for those equities that were overpriced and not in the entire market.*

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