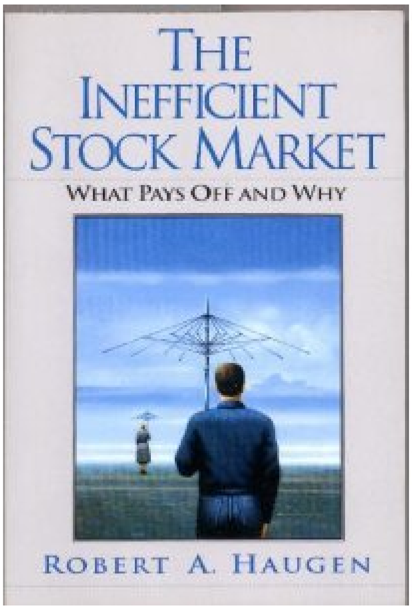
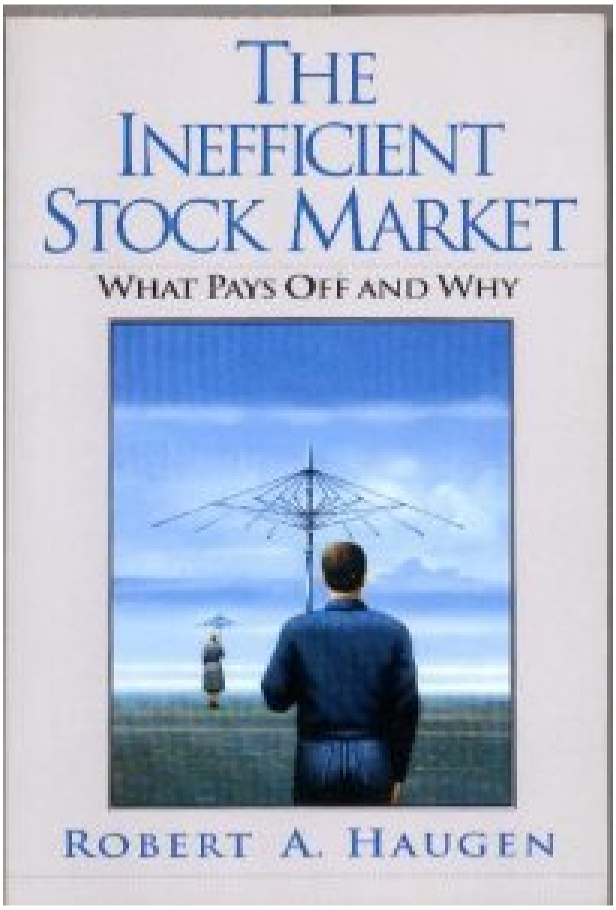
THE INEFFICIENT STOCK MARKET: WHAT PAYS OFF AND WHY BY ROBERT A. HAUGEN

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From the Back Cover
Showing savvy financiers how to beat the stock market, this witty and insightful guide provides clear and undeniable evidence that the stock market is, in the author's view, inefficient - and that important aspects of market behavior can not be explained by models based on rational economic behavior. Tackles important issues in today's financial market in a highly conversational and entertaining manner that will appeal to many readers. Shows how to measure the payoffs to stock characteristics (factors), and provides clear explanations of the CAPM and the APT. Discusses risk and expected return factor models. Predicts international stock returns, analyzes the characteristics of individual stocks that are associated with high returns, and delves into such topics as the payoffs to risk liquidity, profitability, and a stock's performance in past periods. Considers why cheap, profitable, and low risk stocks tend to produce high returns, and takes readers into the land of "Super Stocks". For Pension Officers, Security Analysts, and Financial Planners.

About the Author

Robert A. Haugen is Emeritus Professor of Finance at the University of California, Irvine. Professor Haugen has held endowed chairs at the University of Wisconsin, the University of Illinois, and the University of California. He is the author of more than 50 articles in the leading journals in finance and 13 books, including The Incredible January Effect, The New Finance, Beast on Wall Street, and Modern Investment Theory. He serves as Managing Partner to Haugen Custom Financial Systems, which licenses portfolio management software to 25 pension funds, endowments, and institutional and high-net-worth money managers. Visit Robert Haugen's Web site at: www.bobhaugen.com .

Factor models have been widely employed in the investments business for decades. Quantitatively oriented managers have used them to control the month-to-month variation in the differences between the returns to their stock portfolios and the returns to the stock indices to which they are benchmarked. These models employ a wide variety of ad hoc factors that have been shown to be effective in predicting the risk of a stock portfolio.

Factor models have also been widely discussed in academic finance. Finance professors have long searched for the factors that account for the extent to which returns are correlated stock to stock. The professors have correctly concluded that the correlations can be explained by a few factors, such as unexpected changes in industrial production, inflation, or interest rates. This is not to say that these few factors can match the success of the wide variety of ad hoc factors used in the business for forecasting risk.

The professors have also used factor models to explain why stocks have differential expected returns. These models are theoretical in nature, and are derived under the assumption that pricing in the stock market is efficient and rational. If it is not, a wide variety of ad hoc factors may be useful in explaining and predicting expected stock returns.

Until recently, ad hoc factor models have not been employed to predict the expected return to stock portfolios. Surprisingly, the factor models are much more powerful in predicting expected return than they are in predicting risk. The purpose of this book is to demonstrate and explain the nature of this power.

I wish to thank Teimur Abasov, David Friese, and David Olson for research assistance. I have also benefited from the comments of Mark Fedenia, Joseph Finnerty, Jeremy Gold, Tiffany Haugen, Thomas Krueger, Robert Marchesi, Cheryl McCaughey, Ray Parker, Neal Stoughton, Manuel Tarrazo, and Ole Jakob Wold. Much of the original work was done jointly with Nardin Baker. The idea for this book was suggested to me by Paul Donnelly.

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Sparked with wry wit and humor, this clever and insightful text provides clear and undeniable evidence that the stock market is, in the author's view, inefficient, and that important aspects of market behavior cannot be explained by models based on rational economic behavior. Intended for Financial Markets and Institutions, and Money and Capitals Markets courses at the undergraduate level. *Tackles important issues in today's financial market in a highly conversational and entertaining manner that will appeal to most students, with relatively short, 'punchy' paragraphs that entice readers to go on. *Provides clear explanations of the CAPM and the APT. *Analyzes the characteristics of individual stocks that are associated with high returns. *Predicts international stock returns. *Considers why cheap, profitable, and low risk stocks tend to produce a high return. *Looks into such areas as the payoffs to risk liability, profitability, and a stock's performance in past periods.

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Most helpful customer reviews

3 of 4 people found the following review helpful.
I spent a lot of time trying to faithfully algorithmically recreate his super stock model
By S li
I purchased this book because I am interested in algorithmic trading. A significant part of this book is spent deriving and validating a "super stock" factor model that Haugen suggests can beat various other metrics over time. I spent a lot of time trying to faithfully algorithmically recreate his super stock model. I ran it in backtests over various periods of time over the last few years and even tried simulating a portfolio of "super stocks" in real time.

They totally bombed. As far as I can tell, the reason for this is that the "super stock" model has a propensity to buy a lot of distressed assets (FreeSeas, for instance, was one of its top-ten favorites.)

This book is definitely geared towards the layman. There are times when he spends a lot of time explaining in words what could be written as a simple matrix equation. The issue is that it seems to me that any layman who took the time to recreate his factor model would be very disappointed. It's entirely likely that the market is inefficient. Unfortunately, it may be the case that the particular ways that the market is inefficient today simply aren't knowable, or that the market has now priced in his factor model. Whatever the case may be, if you're looking for a winning trading model as a layman, it's not here. If you're looking for a mathematical basis of understanding the inefficiencies in the stock market, that's not here either. I'm not sure that there exists a group of people for whom I would recommend this book.

At the very least, if Haugen seriously believes that his model is valuable, the next edition of this book should include some software component to help the reader pick out and use his factor model so that they may more easily verify it for themselves.

2/5. Cannot recommend.

39 of 46 people found the following review helpful.
What may pay off a little bit, and why
By Bruce_in_LA
One major school of investment and finance is that markets are so efficient, or, so random, that it is virtually impossible to consistently beat the market. (Remember that half are always above average, and exactly half are always below average.) Readers of "The Experts Pick:..." columns in business magazines or the Wall Street Journal may recognize that such national investment experts fail in their "best" stock pick about half the time, or, in the case of the WSJ, a "dartboard" (literally) performs about as well as half the experts. There is a school of Finance (folks with PhDs) who work on proving this is so. Inefficient Stock Market is a fairly complex work, with lots of graphs and tables, which shows that fairly complex models with dozens of factors may beat the market - by a few percentage points, sometimes. The author is indeed very knowledgeable and writes clearly (given his sophisticated material). But don't expect a "get rich quick" theory of investment. You know, the market is too efficient to allow that ! It's not really behavioral finance (except in his criticism of the status quo). It's something of a very sophisticated approach to "value investing", with the goal of securing a few extra percentage points of return over an index fund. Note: this is not a book for starters. You should know something about the stock market and investing for the whole point of this book to make sense. A book like Lebaron's "ULTIMATE INVESTOR" could give you some background knowledge for this book.

40 of 46 people found the following review helpful.
The Inefficient Stock Market, What Pays Off and Why
By skipper and mate
Ever since I finished my MBA in 1985, I have suspected that the stock market is volatile and inefficient. I have studied Markowitz, the CAPM, and other elegant mathematical models of the market that indicate the market (ex. S&P 500) cannot be beaten. This book claims it can and I believe Haugen is really on to something big.
I have been a non-financial scientific and technical analyst for a company doing business primarily with the defense department for over twenty years and found the analysis techniques presented in the book to be completely rational and apparently based on a very sound statistical approach.
This is the most refreshing approach to reality investing I have yet read. I intend to read the other two books in the trilogy.
If you want to break out of the Modern Portfolio Theory mold, read it.

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