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OUTSIDE THE FLAGS

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A Question of Equilibrium

"Sellers were out in force on the market today after negative news on the economy." It's a common line in TV finance reports. But have you ever wondered that if there are so many sellers out there, who is buying?

The notion that in down days sellers outnumber buyers doesn't make sense. What the newscasters should say, of course, is that prices adjusted lower because would-be buyers weren't prepared to pay the former price.

What happens in such a case is either the would-be sellers sit on their shares or prices adjust lower until supply and demand come into balance. This is when transactions occur and is described by economists as "equilibrium".

But equilibrium isn't a permanent state. That's because new information is coming into the marketplace continually, forcing would-be sellers and would-be buyers to constantly adjust their expectations.

That new information might be company-specific news on earnings. It might be news that has implications for specific industries – like a spike in oil prices. Or it might be an economic development that affects the entire market, like an unexpected change in interest rates.

Given this constant flux in the flow of news and information and the changing expectations of participants, individual securities and the market itself are said to be always moving *toward* equilibrium.

When security prices are falling, it can be reassuring to remember that supply and demand must come into balance for trades to occur. Buyers eventually see value in the market and will invest if the prices are low enough.

Trying to time these inflection points with any reliability is tough. That's because prices at any point reflect the combined expectations of all market participants based on current publicly available information. If the information changes, prices may change. But that requires an ability to both forecast news and to anticipate correctly how markets will respond to that news.

Here's an example from outside the share market to explain how market equilibrium works: Back in early 2011, a cyclone devastated about 75% of the banana crop in the Australian state of Queensland, which produces more than 90% of the national crop.

With supply short, retail prices for the fruit soared from around $3 to nearly $15 a kilogram within months. Farmers who had already harvested their crops sold at significant margins. Many consumers stopped buying bananas altogether because the prices were just too high for their tastes.

But then prices stopped rising as consumers pulled away from the market. And, as full supplies slowly returned, prices gradually fell to end the year back down where they began.

Similarly, security prices rise and fall continuously based on a multiplicity of influences, including supply and demand, news about the individual company and its industry, developments in the economy or even general expectations about the share market.

Trying to untangle all these influences and second-guess the prices which reflect the combined wisdom of would-be buyers and sellers is a near impossible ask.

An alternative approach is to start by accepting that prices are fair and point to the collective expectations of market participants. While information frequently changes, this is quickly built into prices. Competition among buyers and sellers is such that it's extremely hard to outguess the market.

The second step is to see that fairly priced securities can have different expected returns. And we can use market prices and security characteristics to identify those securities that offer higher expected returns.

The third step is to build highly diversified portfolios around these broad drivers of return, while implementing efficiently and keeping costs low.

The final step is staying disciplined and rebalancing your portfolio occasionally to stay within your chosen risk parameters or to adjust for changes in circumstances.

Ultimately, the market is like a giant weighing machine. All those influences mentioned above are constantly being assessed by millions of participants. And prices constantly adjust based on those collective expectations.

The premiums we expect from investing are not there every day, every month, every week or even every year. But the longer we stay invested, the more likely we are to capture them. And, in the meantime, we can improve the reliability of outcomes by diversifying.

So, rest assured, even when prices are falling there are still people buying. The market is doing its job and the rewards will be there if you remain disciplined and diversified.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognized by Australia's corporate regulator in its own investor education program.

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