

Recommended Read: The New Finance - The Case Against Efficient Markets – by Robert A. Haugen

Robert Haugen challenges two central pillars of traditional financial theory, namely the Efficient Market Hypothesis (EMH) and the Capital Asset Pricing Model (CAPM). Drawing on empirical evidence and clear logic, he argues that markets are not fully efficient and that conventional measures of risk often fail to explain real-world investment returns.

The book offers a practical framework for understanding why mispricing persists and how disciplined investors can benefit from recognising structural inefficiencies. Its implications extend across portfolio construction, risk management, and long-term investing.

Market Efficiency Reconsidered

Haugen begins by questioning the assumption that markets quickly and accurately price securities based on all available information. Traditional finance theory implies that excess returns should be difficult to achieve consistently because prices adjust rapidly to new information.

In contrast, Haugen presents evidence that markets often exhibit predictable pricing errors, driven by behavioural biases and institutional constraints. These inefficiencies are not purely random; they can persist over time and create opportunities for disciplined investors. The key implication is that markets are not perfectly rational systems. Instead, they reflect human behaviour and are therefore vulnerable to emotion, overreaction, and misjudgement.

Risk and Return: A Flawed Relationship

A central argument in the book is Haugen's critique of the traditional risk-return trade-off. CAPM suggests that higher risk, typically measured by volatility or beta, should be rewarded with higher expected returns. Haugen shows that this relationship often breaks down in practice. Low-risk stocks frequently generate returns equal to, or better than, high-risk stocks, thereby directly challenging established theory.

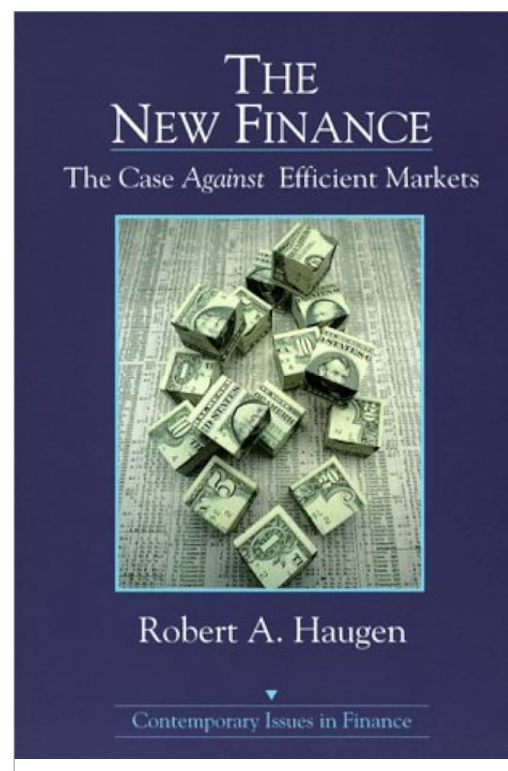
This leads to one of the book's most important conclusions – risk as conventionally defined is not necessarily a reliable guide to expected return. Haugen argues that equating volatility with risk can lead investors to misunderstand the true drivers of

return. Risk should instead be assessed through fundamentals, valuation, and cash flow sustainability, rather than price fluctuations alone.

The Low-Volatility Anomaly

One of Haugen's most compelling insights is the low-volatility anomaly, which is the observation that lower-risk stocks can outperform higher-risk stocks over time. He shows that markets often misprice volatility, with high-volatility stocks tending to be overpriced and low-volatility stocks tending to be underpriced.

This pattern reflects investors' preference for "lottery-like" stocks with the potential for large gains. As capital flows toward exciting, high-risk opportunities, more stable and



cash-generative businesses are often overlooked. The result is a persistent valuation imbalance, whereby the exciting, high-risk stocks command premium valuations, while the steady, cash-generative businesses trade at discounts. Over time, this creates an opportunity for investors who prioritise quality and stability over speculation.

Behavioural Drivers of Mispricing

Although Haugen wrote before behavioural finance became mainstream, he identifies several psychological forces that help explain persistent market inefficiencies. Common investor behaviours include the tendency to overreact to short-term news, extrapolate recent trends too far into the future, and chase high-growth stocks.

Institutional pressures reinforce these biases. Benchmarking, career risk, and the need to remain close to consensus can encourage managers to follow the crowd, even when they recognise potential mispricing. Prices reflect both the available information alongside the behaviour of those interpreting it. Together, these behavioural and structural forces help explain why inefficiencies can persist, even in highly competitive markets.

Valuation as the Primary Driver of Returns

Haugen places valuation at the centre of long-term return generation. Rather than relying only on traditional risk measures, investors should focus more on starting valuation levels, cash flow generation and the reinvestment opportunities for the companies in question.

Because sentiment and narrative can drive a wedge between price and intrinsic value, markets frequently misprice companies in ways that valuation-conscious investors can exploit with the core principle being relatively simple: returns are driven by what you pay, not just what you own.

Portfolio Construction and Practical Implications

The insights in *The New Finance* have clear implications for portfolio management. Investors should seek to allocate capital toward high-quality and low-volatility companies and avoid overpaying for high-growth or speculative assets, all while focusing on long-term compounding rather than short-term fluctuations.

More broadly, Haugen's work supports an investment framework built around stability, cash flow durability, and disciplined capital allocation. These principles remain highly relevant to modern factor investing and quality-focused portfolio strategies.

Why It Matters for Investors Today

Haugen's arguments remain especially relevant in today's market environment, where capital often moves quickly toward the most exciting narratives such as artificial intelligence and momentum-driven themes. These trends can create powerful opportunities, but they can also push valuations well beyond what fundamentals can ultimately justify.

For investors, the practical lesson is not to reject innovation or growth, but to remain disciplined about price, quality, and risk. Haugen's work is a reminder that the market regularly confuses excitement with opportunity and volatility with risk. A business can be popular, fast-growing, and widely owned, yet still be a poor investment if too much optimism is already reflected in its price.

His framework is particularly useful for investors focused on long-term compounding because it encourages a balance between fundamental quality and valuation discipline. It supports the idea that attractive returns are often found in companies with durable cash flows, resilient business models, and underappreciated stability, rather than in the most fashionable areas of the market.

In practical terms, Haugen's message encourages investors to constantly question whether market prices fully reflect fundamentals or simply reflect prevailing sentiment, and to look for quality businesses that are overlooked because they appear steady rather than exciting, all while remaining valuation-sensitive, especially when popular themes become crowded.

Conclusion

The New Finance challenges deeply embedded assumptions about markets, risk, and return. By showing that traditional models fail to explain observed outcomes, Haugen offers a more realistic lens for understanding how markets actually behave.

The book highlights the importance of behaviour, incentives, valuation, and mispricing in shaping investment outcomes. It also reinforces the need to remain sceptical of accepted frameworks and to question conventional definitions of risk. Overall, Haugen's message is clear: long-term value creation is less about accepting more volatility and more about identifying where the market misunderstands risk, return, and intrinsic value.