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WATCHPAD

Ken Kam and Market Efficiency

DANIEL B. KLEIN*

[Abstract, Keywords, JEL Codes](#)

THE ECONOMIST BURTON G. MALKIEL, A PROPONENT OF THE efficient market hypothesis, writes in the *Journal of Economic Perspectives*: “I will use as a definition of efficient financial markets that such markets do not allow investors to earn above-average returns without accepting above-average risks” (Malkiel 2003, 60). Here I propose to broadcast to anyone who can read this little article an investment opportunity that offers above-average returns and lower-than-average risks.

How Masters 100 Fund Works

An entrepreneur named Ken Kam has created a website that simulates bona fide stock trading. He invites all comers. A contestant can sign up and virtually manage more than one portfolio, each portfolio starting with one million virtual dollars. Kam tracks their virtual performance, and then picks 100 of the contestants to be the actual stock pickers for the actual mutual fund, the Masters 100 Fund. The ticker symbol is MOFQX. MOFQX is a fund owned by Kam’s company Marketocracy.¹

So, Rupert goes to the website, as you and I can, and starts virtual trading (let’s assume he has just one virtual portfolio). After a year or two

* Department of Economics, Santa Clara University.

¹ <http://www.marketocracy.com>.

his performance is so good that Kam instates him as one of the 100 masters for the new month, say October. During the period October 1 to October 31, Rupert's trades are actually implemented by MOFQX in real time. Rupert's trades for October also augment and count on his own personal track record. The following month Kam and his team revise the set of 100 masters. The monthly decision of whom to put in the 100 group is based on the traders' performance history. It is not a fixed or formal algorithm. Kam opened the virtual field in July 2000, so for some contestants the track record is more than 3.5 years. At present there are about 55,000 active contestants competing to be selected each month as a master.

Ken Kam is the fund manager of MOFQX. But he does not pick stocks. He and his team pick and revise formulas for instating masters into the one-month tenure as a stock picker. Members are rewarded for being instated as masters. At the website you can learn the details on being a contestant, managing a portfolio, and being remunerated as a master.

It Seems to Work

Kam began the virtual competition in 2000, but the actual trading, the mutual fund, began in November 2001. Table 1 shows cumulative and annualized returns compared to S&P 500, NASDAQ, and DJIA. Figure 1 shows performance (returns including dividends, clear and away after all trading costs and after the annual MOFQX fund fee of 1.95 percent) of MOFQX versus the S&P 500 for the roughly 2.3 years from the inception of MOFQX through 29 February 2004. The data used here is the legally reported information and is available at the MOFQX website. The inset shows that the conventional measure of volatility "Beta" is 0.48, versus 1.0 for the S&P 500.

Table 1: Cumulative and Annualized Returns

Returns as of 29 February 2004				
	Cumulative		Annualized	
	YTD	Since Incept.	Avg. 1-Year	Ave. Annual Since Inception
MOFQX	5.91%	47.70%	59.25%	18.28%
S&P 500	3.25%	8.07%	38.62%	3.40%
NASDAQ	1.39%	14.32%	52.64%	5.94%
DJIA	1.60%	18.04%	37.29%	7.41%

Source: Legally reported data from MOFQX.

**Figure 1: Inception to Date Performance
(as of 29 February 2004)**



Source: Legally reported data from MOFQX.

Possible Explanations of the Standing Success

When someone comes home from Las Vegas a winner, we say he was lucky. But when he comes home a winner 90 of 100 visits, we figure it is more than luck.

The track record of MOFQX would seem to satisfy the law of large numbers. Most importantly, largeness seems to be satisfied by the following numbers: (1) the number of positions held by MOFQX (the number has never been below 700 and is now about 1200), (2) the diversification of positions (it is rare that the largest position exceeds 2 percent of the fund),² (3) the number of percentage points by which MOFQX has beaten the S&P 500, and (4) the number of days of success (more than 2.3 years). And other numbers in the mix are large: (5) the number of positions each contestant must hold in his virtual portfolio,³ (6)

² The statement requires a minor qualification: The Fund invests in S&P Depository Receipts (SPDRs) as a substitute for all positions that are each too small to buy individually, and the Fund's investment in SPDRs is typically between 2 and 6 percent of the Fund. In a technical sense, then, SPDRs is typically the largest "position" in the fund.

³ Each contestant's largest position must not comprise more than 25 percent of his portfolio, and 50 percent of his portfolio must consist of positions each less than 5 percent of the portfolio. Thus, the absolute minimum number of positions in a portfolio is 13.

the number of contestants (some 55,000), (7) the number of “masters” (100 at any given time and changing every month), and (8) the diversification by the standard industry sector and “style” categories. Every number in the scheme is large. If a mutual fund determined comparable daily trading by throwing darts, the likelihood of it performing as far above the S&P 500 as MOFQX has would probably be one in a billion, or something like that.

Still, maybe in a subtler way luck is the explanation. Maybe MOFQX has enjoyed some kind of fortuitous bias. Suppose the whole MOFQX strategy tends to get MOFQX disproportionately invested in some types of positions. The types might be defined by industry sector, by firm capitalization size, or by “style.” As noted, these standard categories don’t seem to provide a ready explanation. But maybe the fortuitous bias selects for certain types of positions in terms of some other, unknown and possibly unknowable typology of positions. By “tends” I mean that, if all types were to perform equally, MOFQX would, for whatever reason, invest disproportionately in, or gravitate to, some particular types. One could potentially explain the success of MOFQX by the fact that those types happened to do well during the past couple of years. It is one among a field of about 7,600 publicly traded mutual funds, and some of these are bound to get lucky. And each lucky fund is bound to have a true believer touting the success as something more than luck. Maybe MOFQX has enjoyed fortuitous bias, and I’m that jackass.

But then there is the other explanation: The scheme works. Contestants might hit upon interpretations and veins of information that are valuable, even if only for a period. These interpretations both make them winners in the competition (and hence masters) and make their ensuing picks as masters good ones.

The master might believe in the winning interpretation for the wrong reasons. In other words, the MOFQX strategy might manage to capitalize on the survivor principle as applied to interpretations, judgments, and veins of information, even if those things are generated randomly (Alchian 1950). Alternatively, masters might simply arrive at and act on superior interpretations—whether it is rooted in superior information, superior interpretive powers, or superior judgment. That is, they “put stock in” winning interpretations for right reasons.

If MOFQX selects for winning interpretations, fantastic. It doesn’t matter whether winning trades are based on random experimentation or on superior insight and judgment. It doesn’t matter if masters “deserve” to be masters.

I am very much inclined to believe that MOFQX works.

“But if you’re so smart, why ain’t you rich?” To that I can respond: By virtue of believing in and acting on MOFQX, I am richer than I otherwise would have been.

An Entrepreneurial Discovery

Friedrich Hayek (1978) and Israel Kirzner (1985) have emphasized that the greatest virtue of free competition is the propensity to discover previously unknown opportunities that correspond to social betterment. Assuming that MOFQX works, Ken Kam will have illustrated the Hayek-Kirzner point on two levels. First, the competition in virtual trading is a form of Hayekian discovery process; it discovers the traders with superior knowledge. Second and more fundamentally, MOFQX is itself a discovery that Kam, one entrepreneur in a fairly free market, has discovered and brought to the investment world. The whole idea of MOFQX is a new interpretation of how one may use available technology to go about picking stock pickers. It is an epiphany, an inspired idea made real. Kam transcended the conventional interpretation of how to go about picking stocks (or, rather, picking stock pickers). He has brought a new interpretation to the field, an interpretation that was there for thousands of others to grasp but was seen and seized only by him.

Regulations tend to regiment industries and to lock in conventional interpretations. Fortunately, regulations of the mutual fund industry were not so restrictive as to lock in the conventional interpretation and make the MOFQX idea moot.

When it dawned on Kam, the primordial insight behind MOFQX was new knowledge. It would not be good English diction to call Kam’s gain in knowledge an acquisition of new information. A defense of the free enterprise system that flattened knowledge down to information would do a poor job of relating its virtues in generating and advancing discoveries like MOFQX. An understanding of economics that allowed such flattening would likely under-appreciate those virtues. As noted by most game theory textbooks, the whole model-building genre depends on the “common knowledge” assumption, which means that all knowledge between agents in the model is uni-interpretational, or that knowledge is flattened down to mere information. The “top” journals publish thousands of papers on asymmetric information, but that kind of economics has not figured out how to deal with *asymmetric interpretation*, and hence simply ignores it, even

though it is the ubiquitous, ineradicable condition of real-life economic processes.

Kam is making profits, but the concomitants include better capital markets, better investment projects, and better living conditions for people in general. Joy tips her hat to Ken Kam.

Assuming the strategy works, eventually it will become self-limiting. If Kam just let the fund grow and grow, and implements the same formula of trades but at greater and greater volumes, it will be moving prices to such an extent that it will do less well than at lower volumes. Presumably he won't let things balloon in that fashion. But he cannot control the competition. The strategy will no doubt be replicated (contestants will probably be able to play a portfolio in both Kam's contest and in a competitor's contest), so competition will eventually push things back to "normal returns"—returns, that is, for the fund and for schmos like us, not for the superior stock pickers (their rewards will rise). But Kam seems to have at least a two year jump on the competition, so I am keeping my money parked.

The Efficient Market Hypothesis: How Rapid is Rapid?

Does Ken Kam falsify the efficient market hypothesis? If not, why not? And if not, what would?

Burton Malkiel writes: "Many of us economists who believe in efficiency do so because we view markets as amazingly successful devices for reflecting new information rapidly" (2003, 60). May we presume that here the expression "new information" means "new knowledge"? Perhaps not: perhaps that distinction tells all and allows efficient market proponents to squirm out of frontal empirical challenges. On the other hand, if we may substitute "new knowledge" for "new information" in Malkiel's statement, the question becomes: How rapid is rapid? MOFQX debuted in November 2001 with about \$3 million and has grown to \$91 million (as of 7 March 2004). How long it will take to reach \$100 billion is to be seen. Is the path of fund growth sufficiently rapid to satisfy the efficient market hypothesis?

I leave these questions to others. I wish to suggest that MOFQX illustrates market efficiency in an altogether different sense: Blessed discoveries—as MOFQX appears to be—are, by and large, more likely the freer the market.

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