ABSTRACT In this review article, we explore several recent advances in the quantitative modeling of financial markets. We begin with the Efficient Markets Hypothesis and describe how this controversial idea has stimulated a number of new directions of research, some focusing on more elaborate mathematical models that are capable of rationalizing the empirical facts, others taking a completely different tack in rejecting rationality altogether. One of the most promising directions is to view financial markets from a biological perspective and, specifically, within an evolutionary framework in which markets, instruments, institutions, and investors interact and evolve dynamically according to the “law” of economic selection. Under this view, financial agents compete and adapt, but they do not necessarily do so in an optimal fashion. Evolutionary and ecological models of financial markets is truly a new frontier whose exploration has just begun.

If, in January, 1926, an individual invested $1 in one-month U.S. Treasury bills—one of the safest securities in the world—and continued reinvesting the proceeds month by month until December, 1996, the original investment would have grown to $14. If, on the other hand, an individual invested $1 in the S&P 500—a much riskier investment—over the same 71-year period, this investment would have grown to $1,370, a considerably larger sum. Now suppose that, each month, an individual were able to divine in advance which of these two investments would yield a higher return for that month and took advantage of this information by switching the running total of his initial $1 investment into the higher-yielding asset. What would a $1 investment in such a “perfect foresight” investment strategy become by December 1996?

The startling answer is $2,296,183,456, more than two billion dollars! Despite the fact that perfect foresight in financial markets is impossible, this example suggests that even a modest ability to forecast financial asset returns may be handsomely rewarded. Of course, there are considerable risks involved. As recent financial calamities such as that of Long Term Capital Management have made very clear, it is also possible to lose very large sums of money. Financial markets are very difficult to predict; otherwise, we would all be rich. One of the central questions, indeed, perhaps the most central question in finance, is, “Under what circumstances is prediction possible at all?”

In this review article, we explore this issue in light of recent advances in the quantitative modeling of financial markets. The potent combination of breakthroughs in financial technology and computational speed and efficiency is creating an exciting renaissance in financial research, both inside and outside the halls of academia. It is impossible for us to provide a complete survey of these developments here; instead, we focus on the beginnings of a new research direction that the emerging fields of computational finance and financial engineering may be heading toward—

Frontiers of finance: Evolution and efficient markets

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Abbreviation: EMH, Efficient Markets Hypothesis.
One of the reasons for this state of affairs is the fact that the EMH, by itself, is not a well posed and empirically refutable hypothesis. To make it operational, one must specify additional structure: e.g., investors' preferences, information structure, etc. But then a test of the EMH becomes a test of several auxiliary hypotheses as well, and a rejection of such a joint hypothesis tells us little about which aspect of the joint hypothesis is inconsistent with the data. Moreover, new statistical tests designed to distinguish among them will no doubt require auxiliary hypotheses of their own that, in turn, may be questioned. The hypothesis that investors are fully rational agents that instantaneously and correctly process all available information is clearly unrealistic—rationality is difficult to define, human behavior is often unpredictable, information can be difficult to interpret, technology and institutions change constantly, and there are significant "frictional" costs to gathering and processing information and transacting. But how can we take all of the complexities of the real world into account?

One new direction is to treat the EMH as an idealization that provides a useful reference point. For example, one can ask about the relative efficiency of markets with respect to each other: e.g., futures vs. spot markets, auction vs. dealer markets, etc. The advantages of the concept of relative efficiency, as opposed to the all-or-nothing notion of absolute efficiency, are easy to spot by way of an analogy to the concept of efficiency as used in physics. Heat engines can be given an efficiency rating based on the fraction of available energy that they convert into useful work. A refrigerator with an efficiency of 40% might be considered quite good, and a buyer would prefer this to one with an efficiency of only 35%. No one would ever expect 100% efficiency. The best measure of the relative efficiency of financial markets, relative to each other, is a topic on the frontiers of research in finance.

Another point of view is to extend the definition of efficient markets so that consistent profits are possible to those who acquire a competitive advantage. The motivation for this becomes apparent from applying the classical version of the EMH to a nonfinancial context, such as a biotechnology firm attempting to develop a vaccine for the AIDS virus. If the market for biotechnology is efficient in the classical EMH sense, such a vaccine can never be developed—if it could, someone would have already done it! This is clearly an absurd conclusion because it ignores the challenges and gestation lags of research and development in biotechnology. If a pharmaceutical company does succeed in developing such a vaccine, the profits earned might be measured in the billions of dollars—would this be considered "excess" profits or simply an appropriate economic reward for competence and innovation? Financial markets should not be different in principle, only in degree. The profits that accrue to an investment professional need not be a market inefficiency but may simply be the fair reward for unusual skill, extraordinary effort, or for breakthroughs in financial technology.

What, then, can we conclude about the EMH? Amazingly, there is still no consensus among financial economists. Despite the many advances in the statistical analysis, databases, and theoretical models surrounding the EMH, the main effect has been slow to develop. Recent research in finance suggests that this is about to change (5). Although there are obvious differences between evolution in biological systems and evolution in financial systems, there are also many similarities. The theory of evolution may prove to be as powerful an idea in finance as it has been in biology. There is no lack of quantitative data, and there are many opportunities for biological principles to be applied to financial interactions—after all, financial institutions are uniquely human inventions that provide an adaptive advantage to our species. This is truly a new frontier whose exploration has just begun.

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