Fischer Black should be a well-known name to anyone involved in investing in capital markets. He and Myron Scholes developed the Black-Scholes option-pricing model. Scholes and Robert Merton won a Nobel Prize for this work, and Black would have also won such recognition. Sadly though, Black passed away a few years before the Nobel committee awarded the prize (and Nobels are not awarded posthumously).

Black contributed in many areas of finance, econometrics and macroeconomics. His work ranged from applied investing, to developing macroeconomic theory regarding causes of booms and inflation.

In addition to teaching at the University of Chicago and MIT, Black also worked with Goldman Sachs developing in-house derivatives trading models. Some of Black’s work with Goldman involved proprietary and confidential trading strategies, while other work was eventually published and made public.

A close friend of mine, engaged in his career as a well-respected academic and policy maker, recommended Black’s *Noise* as useful starting-point for discussing capital markets and investing. One of Black’s key points is the existence of two types of traders: information traders and noise traders. Information traders trade based upon valid insight about the intrinsic value and market prices of securities. Noise traders trade for a variety of reasons. They might think they possess insight or they might just enjoy trading. Of course, noise traders often incorrectly believe they’re trading on information. Often times they are either naïve or just plain wrong. Unwittingly, many readers of this review may be noise traders themselves.

Why do traders trade on noise and not on information? First, efficient market theory states that all material information is incorporated into security prices. However, this is pragmatically impossible. Too much information exists, especially in the digital age, to routinely incorporate all data into trading models. Second, even if a trader could gather all relevant information, it would be impossible to process it in real-time and make appropriate trading decisions.

Instead of trading on all available information and rational, utility-maximizing strategies, many traders use rules of thumb. These rules of thumb come from different places: for example people who apply CAPM need to determine an appropriate risk premium. For many, the proper number remains a function of when they attended business school and what their finance professor taught them at the time.
Noise traders also trade on what they believe is information, though there may be little consensus about informational validity. Think about the differences between the book to market measures preferred by traditional value investors, support and resistance levels used by technicians, and Fibonacci sequences used by...well I do not personally know many who apply the “golden ratio”, but some traders clearly do so. Traders use such drastically different decision developing frameworks that, by definition, some may be valid while others must just be plain wrong. Some who consider themselves information traders are in fact noise traders.

Black concluded that noise traders are essential for providing liquidity, and creating profit-making opportunities in markets. Without noise traders, there would be few price disruptions and little need to actively trade securities. Liquidity would be much, much lower. Similarly, noise traders provide an opportunity for information traders to profit. If noise traders make decisions based on inaccurate assumptions and models, then they create opportunities for information traders to exploit price disruptions. Black stated, “…noise trading is essential to the existence of liquid markets.”

So an interesting question to consider is, “how many traders are noise traders, and how do you know whether you’re one of them?” It may be impossible to answer the question, but let’s examine some clues. First, it’s well documented that the vast majority of active money managers under-perform their benchmarks. Fees and trading costs play a role, but so do trading decisions. Second, how much risk are traders taking? Risk itself is difficult to measure. Estimates of risk such as volatility or standard deviation are only coarse attempts to understand risk. Risk is correctly understood in terms of the permanent loss of capital, not merely fluctuation in securities prices. Black implies that exact conclusion. It’s illogical to state that simple increased volatility equates to increased risk over the long term. On the other hand, volatility may equate to risk for short-term holding periods. Long-term investors would be wise to differentiate between true risk (i.e. permanent loss of capital) and short-term price fluctuations. Short-term traders need to think differently, as volatility may indeed lead to permanent loss of capital.

As Black observes, noise traders provide information traders with two valuable opportunities. First is market liquidity and second is price fluctuations that provide profit-making opportunities.

As Black concludes, “People who trade on noise are willing to trade even though from an objective point of view they would be better off not trading...Most of the time, the noise traders as a group will lose money by trading, while information traders as a group will make money.”

In future Reviews, we will examine methods to build our information trading understanding. We will review research that moves beyond “rule of thumb” trading, and towards truly informed decision making.

Jonathan Burgstone serves as Managing Director of Symbol Capital LLC, and is an Adjunct Professor at the University of California Berkeley.

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