

Markets are not efficient: here's what investors must be wary of

Devina Mehra | 22 October 2026



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SUMMARY

For long, the efficient market theory was the prevailing wisdom being taught in universities. But closer inspection reveals why this idea doesn't hold in real life. And who better to guide investors and regulators on how markets can go wrong than George Soros?

As I write this on Vijayadashmi day, I remember the legend that even as Ravana lay dying, Lord Rama asked his brother Lakshmana to sit at his feet as a disciple and get knowledge. In the same spirit, I am sharing insights from George Soros' long record as a successful trader and investor—the very person many in India love to hate.

In fact, whenever anyone has asked me whether even after recognizing a bubble one can play it and get out in time, my answer has been that the only person who has managed to do that more than once at scale is Soros. Others are one-trick ponies who may have been permanently bearish or bullish and got lucky that one time.

Soros' basic insight was that unlike what has been the conventional wisdom, markets are not efficient. When I came into markets over three decades ago, the efficient market theory was the prevailing wisdom being taught in every university—that all available information is already there in asset prices, markets tend to move towards equilibrium and that deviations occur in a random fashion and can be attributed to extraneous shocks.

It was clear to me right away that this did not hold in real life. Think about it: if the price of a stock moves from ₹100 to ₹150 in a quarter when no new information has come, which of the two prices is the efficient one?

A beloved offshoot of this theory is the calculation of 'beta,' which measures how much a stock moves when the market moves by a certain percentage. Again, if you calculate this for each stock, you will find that the beta changes all the time and can hardly be used to predict anything. Soros' insight went a step further to say that not only are markets inefficient, they are inefficient in certain predictable ways.

His framework rests on two cardinal principles. *One*, market prices distort underlying fundamentals, ranging from negligible to significant deviations. *Two*, reflexivity, which means that not only do fundamentals determine market prices, but through feedback loops, especially via leverage like debt and equity, the underlying fundamentals can be altered.

Sometimes this is simple. For example, in a cyclical industry like cement or steel, when the cycle turns up, the worst company gives you the biggest stock market pop because a small operating margin improvement becomes a big change in its net profit and hence share price. Then the company usually raises capital at the higher stock price, reducing debt and making its financials look even better. The stock price reflexively changes the fundamentals.

This is a relatively benign example, but when this happens at scale across a market, it can cause a bubble.

According to Soros, every market bubble comprises an underlying real-world trend and a prevailing misconception that reinforce each other. They progress through four distinct stages.

The inception is when an underlying trend and a misconception turn mutually reinforcing. In most bubbles, there is an underlying trend to start with. Then this mutual reinforcement accelerates if the bubble survives initial negative feedback tests.

In a real estate bubble, for instance, the misconception can be that not only are property prices rising, there is no problem with credit because the loans are secured against real estate. This does not recognize the fact that property prices

are themselves largely dependent on the easy availability of credit. So, it becomes a self-reinforcing loop.

Also, leverage does not only mean excess debt in the system. It can also be over investment and over valuation on the equity side. The latter is largely what happened during the internet boom. Before that, in the 1960s, the US had a conglomerate boom, with companies acquiring others to artificially boost earnings per share, fuelled by inflated stock prices until reality collapsed expectations.

Currently, this is most evident in the artificial intelligence (AI) space, where equity valuations have long lost touch with reality and an estimated \$1 trillion of credit has also gone in to fund AI. Anthropic, a leader in the field, is borrowing in dollars at over 10%.

After the acceleration in the boom comes the twilight period, when expectations diverge wildly from reality and doubts grow, but the momentum persists out of inertia; and when CEOs are telling themselves “to keep dancing until the music stops,” as was said during the mortgage boom before the global financial crisis of 2008-09. This is a suspended animation sort of period.

Finally, reality catches up, triggering a sharp bust. Prices typically go even below fair value due to forced liquidations and financial panic. The pendulum swings the other way.

During the global financial crisis, the BSE Sensex fell from a peak of 21,206 in January 2008 to 8,160 in March 2009—A decline of about 61%. The fact that markets are neither self-regulating nor in equilibrium makes a case for regulatory intervention. Regulators must actively work to prevent bubbles from growing too large, rather than assume that markets are always right.

Indeed, financial crises typically become the impetus for regulatory reform. For example, the US Securities and Exchange Commission came into being as a result of the Great Depression.

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