A Different Approach to Investment

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When a commodity is perfectly uniform or homogeneous in quality, any portion may be indifferently used in place of an equal portion: hence, in the same market, and at the same moment, all portions must be exchanged at the same ratio. There can be no reason why a person should treat exactly similar things differently, and the slightest excess in what is demanded for one over the other will cause him to take the latter instead of the former … Hence follows what is undoubtedly true, with proper explanations, that in the same open market, at any one moment, there cannot be two prices for the same kind of article. Such differences as may practically occur arise from extraneous circumstances, such as the defective credit of the purchasers, their imperfect knowledge of the market, and so on.

William S. Jevons
The Theory of Political Economy (1871)

Entrepreneurial judgment cannot be bought on the market. The entrepreneurial idea that carries on and brings profit is precisely that idea which did not occur to the majority. It is not correct foresight as such that yields profits, but foresight better than that of the rest. The prize goes only to the dissenters, who do not let themselves be misled by the errors accepted by the multitude. What makes profits emerge is the provision for future needs for which others have neglected to make adequate provision.

Ludwig von Mises
Human Action (1949)

Why Do Markets Work So Well?

In unguarded moments and at some rarefied and abstract level, far removed from flesh-and-blood people and the gristle of everyday experience, some mainstream economists, a few business executives, a handful of policymakers – and even one or two politicians – will concede that unfettered markets "work." They grudgingly accept that, given certain very stringent assumptions that never obtain in the real world, profit-seeking producers will provide goods and services in the various combinations of quantity and quality that consumers desire. Further, competition among producers will also ensure that goods and services are provided at the lowest possible price; and competition among bargain-hunting consumers will reward those who can (and penalise those who cannot) supply the most-desired goods and services at the lowest price.

Although they recoil from the use of the phrase, a few élites will occasionally concede that laissez-faire capitalism, at least in the abstract, harmonises individuals' many and varied plans and thereby puts people, capital and technology to their best possible uses. In an unhampered market, price will tend towards the level at which each seller is able to sell all that he desires and each buyer can buy all that he desires. A price that is too high to clear the market will fall as sellers strive to liquidate unsold inventories. And prices that are too low to clear the market will create competition among buyers who have been unable to obtain the desired quantity of the good or service. This competition will place upward pressure upon a price such that it rises to a market-clearing level. The free market economy – the abstract principle is occasionally granted before a barrage of "practical" qualifications is inevitably launched – thereby serves buyers and sellers, consumers and producers and borrowers and lenders better than any other.

Yet a fundamental – and very surprising – void lurks at the very heart of the mainstream conception of markets. As an experiment, ask a conventional economist how a real-life market (as opposed to the abstract and stylised version that inhabits the textbooks and journals) actually operates. In response, you will likely receive an arcane explanation that is riddled with caveats. Contemporary mainstream economists can explain with great sophistication the operation of imaginary markets that conform to stringent assumptions. But they offer startlingly few insights into real-world markets that mock these assumptions.

Typical economists, in other words, describe in great detail make-believe markets whose assumptions guarantee that they "work;" but they say little or nothing about the origins and operations of the actual market processes that generate desirable results in the real world. To members of the general public – and, one suspects, to many politicians, business executives and policymakers – the surprisingly smooth (despite the massive and growing intervention by governments) operation of real-world markets is shrouded in mystery. Accordingly – and whether in Parliament or on the hustings or in the boardroom and classroom or in the editorial pages and letters-to-the-editor – the many benefits of voluntary exchange are usually obscured or denigrated and often flatly denied.

Several premises underlie mainstream economists' conception of markets. The starting point is that they comprise very large numbers of buyers and sellers, and that each market participant possesses clear objectives, prioritises them and decides strictly rationally (i.e., as a priority-maximiser) and without error. When mainstream economists think about markets, they instinctively think in abstract and mathematical terms; and when they think abstractly they almost automatically assume that markets possess the necessary and sufficient characteristics of perfect competition. They assume in particular that stylised market participants possess perfect mutual knowledge. Not only is each buyer and seller fully aware of the decisions made by all other market participants: each is also aware of the decisions that all others would make under every conceivable market situation. Accordingly, perfect competition among buyers and among sellers will ensure that the market for a given good or service is an "equilibrium" market that clears rapidly and effortlessly; similarly, adjustments between markets will also occur swiftly and smoothly.

In the equilibrium world of the conventional economist, there is no scope for the individual or for his inspiration, passion and folly. The course of events in the market is foreordained in the data and the perfectly competitive model; and given the straightjacket into which buyers and sellers are placed; nobody can alter the foreordained sequence of market events. An "exogenous shock" to the system is the only circumstance that can unexpectedly change the sequence. How, then, do mainstream economists analyse change in the market? By the method of "comparative statics." Like time-elapse photography, this method treats change as a sequence of static images. It proceeds from a first snapshot of an inexorably foreordained world (i.e., equilibrium) to a second picture of an inexorably foreordained world (another equilibrium), etc. But what sets change in motion and influences it in one direction or another? What is the process by which the first equilibrium proceeds to the next? Apart from the notion of "exogenous shock," which by definition is beyond the model's ability to explain, the conventional economist has no explicit answer.

Scratch a Mainstream Economist, Sniff an Interventionist

Markets are to owners of businesses and lenders to businesses, i.e., investors, what water is to fish. Clearly, an investor's survival and prosperity presuppose a comprehension of the principles governing the environment he inhabits. So why, from the point of view of an investor, does the mainstream model of perfect competition, its various extensions and elaborations and its totem of equilibrium, provide an unsatisfactory explanation of how markets work? First, the model's requirements do not even remotely refer to real people; accordingly, they do not even crudely approximate reality. If you think that this and the two preceding paragraphs are a fantastic caricature, then peruse Frank Knight's classic articulation of the perfectly competitive market economy (Risk, Uncertainty and Profit, Beard Books, 1921, 2002, ISBN: 1587981262) and any mainstream textbook published since the first edition (in 1948) of Paul Samuelson's *Economics* (McGraw-Hill, 17th ed., 2001, ISBN: 0072314885). You will look vainly for any reference to the role in the market of a concrete individual exercising a free will.

The mainstream model has a second glaring defect: it opens the paddock gate to a variety of distracting pests and damaging predators. Talk to a conventional economist and you will soon realise that you are conversing with someone who eventually (and perhaps readily) concedes that his assumptions about market participants, dynamics and equilibrium apply to a world other than the real world. Alas, when the typical economist thinks about real-world markets his thinking suddenly becomes slipshod – and distinctly interventionist. The typical economist applauds the real-world market economy with only one hand – and on the condition that aggressive government intervention accompanies it. "Grant me chastity and continence," said St Augustine, "but not yet." Similarly, the typical economist mouths market rhetoric and solutions but champions voluntary exchange only under conditions that never exist in the real world.

In the meantime, it is alleged that producers (and various "experts") know far more about medicine and education than do consumers. It thus follows, according to many economists and policymakers (eagerly mimicked by politicians seeking ways to bribe voters), that in order to "protect consumers" and redress these "information asymmetries" and "market failures" the government must arrange and preferably run schools and hospitals and much else. It must also enact torrents of "consumer protection" and other legislation. It is also implied that "public goods" exist, that only governments can furnish them, and that transport networks, "national security" and "the environment" are public goods.

Much more generally, economists and policymakers readily concede not just that most real people possess imperfect or incomplete information but also that they cannot properly assess it. (The anointed, of course, exempt themselves from this characterisation of the benighted). For this reason, they bless the market only if the incomes earned thereon are "corrected" by "progressive" (i.e., high) taxes, if "life chances are improved" by extensive and intrusive welfare programs, and if the property rights of the "greedy" people who decline to acknowledge their "social responsibilities" are weakened by myriad coercive regulations. (All of the words and phrases within quotations were observed in *The Australian* and *The Australian Financial Review* during the week of 13-17 September 2004).

What has become mainstream economics has long contained many interventionists – and a few closet totalitarians. The preface to the German-language edition of *The General Theory of Employment, Interest and Money* (1936), for example, pandered openly to National Socialists – which is why they happily consented to the book's publication and dissemination throughout the Third Reich. John Meynard Keynes wrote in the preface "the theory of aggregate production that is the goal of the following book can be much more easily applied to the conditions of a totalitarian state than the theory of the production and distribution of a given output turned out under the conditions of free competition and of a considerable degree of laissez-faire." Few of the book's many other statements were so accurate.

Typical was Keynes's convoluted and utterly fantastic claim "to suppose that a flexible wage policy is a right and proper adjunct of a system which on the whole is one of laissez-faire, is the opposite of the truth. It is only in a highly authoritarian society, where sudden, substantial, all-round changes could be decreed that a flexible wage-policy could function with success. One can imagine it in operation in Italy, Germany or Russia, but not in France, the United States or Great Britain." To Keynes, apparently, laissez-faire meant non-adjustment, authoritarianism denoted flexibility and elasticity signified rigidity. In many respects *The General Theory* should be read in conjunction with George Orwell's *Nineteen Eighty-Four* – both books describe a world in which up is down, war is peace and freedom is slavery.

Keynes and his vast number of contemporary descendants, safely tenured within universities and the civil service, neither champion the free market nor condemn coercion. For years, Paul Samuelson adopted this ambiguous position. According to Mark Skousen (The Perseverance of Paul Samuelson's Economics), his text "ranks with the most successful textbooks ever published in the field, including the works of Adam

Smith, David Ricardo, John Stuart Mill and Alfred Marshall. Its [17] editions have sold over four million copies and have been translated into 41 languages." It "has so dominated the college classrooms for two generations that when publishers look for new authors for a principles of economics text, they say that they are searching for the 'next Samuelson.'" Accordingly, "for members of the economics profession, looking back at Samuelson's text is like looking into a mirror that reflects many of our beliefs. If we are uncomfortable with some of what we see in that mirror, then we must also feel uncomfortable with the version of economics that was taught, and perhaps also uncomfortable with the impact that the teaching of economics may have had on the economy."

Skousen notes that according to Samuelson's first edition (1948), periodic "acute and chronic cycles" afflict private enterprise and government has a responsibility to "alleviate" them. Further, "the private economy is not unlike a machine without an effective steering wheel or governor … Compensatory fiscal policy tries to introduce such a governor or thermostatic control device." By the seventh edition (1967), Samuelson had dropped the "machine minus the steering wheel" metaphor but continued to emphasise that "a laissez-faire economy cannot guarantee that there will be exactly the required amount of investment to ensure full employment." If it did occur under free market conditions, then full employment would result from "luck." Samuelson also contended that the "neo-classical synthesis" was "accepted in its broad outlines by all but a few extreme left-wing and right-wing writers." This claim, or one very similar to it, appeared until the twelfth edition in 1985.

In the text's first edition, Skousen also notes, Samuelson was sceptical about central planning. "Our mixed free enterprise system, [despite] all its faults, has given the world a century of progress [that] an actual socialised order might find impossible to equal." By the fifth edition (1961), however, this view had changed considerably. Although he was somewhat sceptical about the reliability of statistics describing the Soviet economy, and whilst he acknowledged that it expanded more slowly than that of Germany, Japan, Italy and France, he concluded that Western economists "seem to agree that [the USSR's] recent growth rates have been considerably greater than [America's] as a percentage per year." The fifth through eleventh editions (1961-1980) included a graph indicating that the "gap" between the American and Soviet economies was narrowing and possibly even disappearing. The twelfth edition declared that between 1928 and 1983 the Soviet economy grew at a remarkable rate of 4.9% per annum – more rapidly than its American, British, German and Japanese counterparts. In the thirteenth edition (1989) Samuelson and his co-author, William Nordhaus, culminated this theme. They declared "the Soviet economy is proof that, contrary to what many sceptics had earlier believed, a socialist command economy can function and even thrive."

Did I hear anybody say that economists are rotten market timers? Did anybody say that they can also be poor economists?

In the fourteenth edition, published during the collapse of the Soviet Union, Skousen wryly observes that Samuelson and Nordhaus dropped the word "thrive" and added the caveat "the Soviet data are questioned by many experts." The fifteenth edition (1995) abruptly dubbed Soviet Communism "the failed model." To their credit, Samuelson and Nordhaus admitted that they and other economists failed to anticipate the collapse of central planning. They might have added that, like most other Western academics, they had long regarded it through rose-tinted spectacles. But now, apparently, they saw things clearly: "in the 1980s and 1990s, country after country threw off the shackles of communism and stifling central planning – not because the textbooks convinced them to do so but because they used their own eyes and saw how the market-oriented countries of the West prospered while the command economies of the East collapsed."

Eyes Still Wide Shut

Unlike Samuelson and Nordhaus, it seems that many – perhaps most – mainstream economists and finance journalists have not yet opened their eyes. In a recent and particularly amusing example, *The Economist* (21 August 2004) chastises China's "communist" government. Its "health care" policy relies too much upon market forces, says this allegedly market-friendly magazine, which urges the government "to spend more on health care." The magazine praises the "health care" policies of Mao Zedong – the man whose agricultural policies caused tens of millions to starve, something that one would think renders doctors, nurses, medicines and hospitals rather pointless. *The Economist* concludes "slowly and reluctantly … China is beginning to discover that market forces alone cannot produce good health care." We truly live in a bizarre world. An embodiment of its logical confusion and moral bankruptcy – and of the continuing pervasiveness of socialism among Western mainstream economists and financial journalists – is the laughable spectacle of "free marketeers" admonishing "communists" because the latter rely too heavily upon market forces.

Far less amusing, because it is much closer to home, is the roundtable *The Australian Financial Review* conducted as part of its coverage of the Commonwealth election with "four distinguished experts." One expert is a former senior Treasury official, acting chairman of the Industry Commission and IMF staffer; another is a former member of the Board of the Reserve Bank; and the other two are senior academic economists. The edited transcript, published on 16 September 2004, makes dispiriting reading for taxpayers and friends of liberty. "I think [the Australian Labor Party] saying it will balance the budget each and every year [and reduce spending as a percentage of GDP] is too tight a promise," said one distinguished expert. "It would perhaps be appropriate for the budget to go into deficit in the short term if there was a recession." Another asked: "do we need to spend more because of market failures [and more on] education, health and so on? Do we need to spend more or less to achieve social equity redistribution?" His answer to the first question was affirmative, and his response to the second was "more."

A third distinguished expert said "any of us that have experienced public transport, roads, education or hospitals in the states must see, I think, that there are considerable areas where increased expenditure would be of a significant benefit." Donning his centralist "Canberra Knows Best" hat, he continued: "having said that, I would also impose on the states rather more micro-economic reform than they've been going to do in the past several years, and the federal government is in a good position to do that. It has the money to do it and it would be a significant addition to our living standards if it did." The fourth expert opined: "I think the hospital situation is really not good in Australia compared to the past. It should really be very much better. The private-public hospital split just makes the public hospitals look worse, and I think we just need to put more money into public hospitals … The other gap I see is the schools. Both have been talked about, but we need to make bigger steps towards getting more money for those areas." God bless Australians – and God protect them from the "distinguished experts" who owe their privileged positions not to their ability to reason, and still less to the correspondence of their policies' actual results to their intended consequences, but rather to their shameless willingness to tell politicians exactly what they want to hear.

If mainstream economists are the market economy's most prominent friends, then it clearly does not lack mortal enemies. Moreover, its many enemies among non-economists have used the mainstream's arcane assumptions and interventionist predilections as clubs with which to attack voluntary exchange and natural liberty (William Coleman, *Economics and Its Enemies: Two Centuries of Anti-Economics*, Palgrave, ISBN 0333790014 provides a good overview). Many of these enemies simply exempt themselves from the rules of rational and civilised enquiry. They feel no need, in other words, to base their criticisms upon logic and evidence (see in particular Andrew Norton's excellent review, entitled The Impossible Pusey, of Michael Pusey's *The Experience of Middle Australia: The Dark Side of Economic Reform*, Cambridge University Press, 2003, ISBN 0521658446. See also William Coleman and Alf Hagger, *Exasperating Calculators: The Rage Over Economic Rationalism and the Campaign Against Australian Economists*, Macleay Press, 2001, ISBN 1876492031).

Probably granting it more coherence than it deserves, non-economists' *modus operandi* is to point to the mainstream's model of perfect competition; draw attention to the obvious respects in which real-world markets fall far short of the conditions the model requires to produce "social welfare optimalities;" wave a dismissive hand and discard the market baby as well as the perfectly competitive equilibrium bathwater. Contemporary mainstream economic theory is thus not only incapable of explaining – or even considering – real-world market processes: it also hands to the many opponents of liberty rhetorical and emotive (as opposed to logical and empirical) ammunition that both economists and non-economists use to assault laissez-faire capitalism.

There is a third reason why the mainstream model of perfect competition does not and cannot explain how markets work: it simply assumes into abstraction many of the concrete things for which investors seek explanations. How do buyers and sellers acquire knowledge? The model does not tell us: it simply assumes that they possess perfect knowledge. How to they evaluate and act upon it? Again, the model does not tell us: it simply assumes that they calculate perfectly and make no mistakes. Most importantly, what is the process by which participation in the market harmonises disjointed plans and actions? Given the model's assumptions, to ask such a question is akin to asking a mathematician to divide by zero. The mainstream's core model does not address – because it is not designed to address – these fundamental questions. The model's "apparent demonstrations," said Friedrich Hayek in *Individualism and Economic Order* (University of Chicago Press, 1949, 1980, ISBN: 0226320936), "amount to no more than the apparent proof of what is already assumed."

The model of perfect competition is a model of hermetically sealed decision-making. It imagines, in other words, that at all times each market participant possesses all that he requires to decide without error. He unerringly maximises something (such as profit) that is subject to known constraints. Each buyer and seller is assumed to possess a clearly defined and rank-ordered set of objectives; each is assumed to know everything there is to know about other buyers and sellers in every transaction in which he might choose to participate; and each is assumed to be fully aware of all of the resources at his and others' disposal. The model assumes that every buyer and seller is in effect pre-programmed to select the optimal response given the data he faces. As a result, and like a bloodless calculating machine, he can never exercise imagination nor be either cautious or reckless. Above all, because he never errs he can never be surprised.

But decisions in the real world are never hermetically sealed. Buyers and sellers are neither coldly rational nor omniscient, and rarely are the resources at their disposal (not to mention others' plans and resources) obvious. It is whilst making decisions that market participants ascertain and clarify their objectives, learn something about others' plans and realise what resources are available to implement them. To buy or sell in the real world is to act in the face of a largely unknown present and future – unknown in the sense that one simply cannot "model" it with a set of data, system of equations and particular probability distribution. From the perfectly competitive model one can readily derive definite theoretical conclusions that are unaffected by the many vagaries and ambiguities of real-world decisions. One of the perfectly competitive model's principal advantages, from the point of view of mainstream economists, is that in its closed-end world there is neither surprise nor error. But what is an advantage to the theoretical economist is a major drawback to the applied investor: the mainstream model downplays and obscures the very forces that pervade real-world markets. Unlike the theoretical decision-maker, the real-life investor is frequently surprised and often errs.

The assumption of perfect knowledge, then, conveniently removes from consideration the inconsistent plans, incomplete or erroneous information and myriad other errors that generate unexpected results in the real-world market. Some strands of the mainstream literature have for decades tried to relax this assumption. Alas, they have done so in a way that remains unsatisfactory from the investor's point of view. This ever more esoteric literature treats perfect information as a costly resource that buyers and sellers may acquire. It is granted, in other words, that market participants may not know everything. But it is assumed that they know the mathematical probability associated with the occurrence of every possible option they face, and they can obtain information that reduces the variability ("risk") of the results of their decisions. As an example, investors might not know the total stream of income that Asset X will generate during the next five years; but it is assumed that they know its "expected value" and the probability that this income lies a given amount above or below this expected value.

The assumptions required by mainstream economists to demonstrate how voluntary exchange in the market generate their beneficial results are far too demanding to apply to – and therefore to make sense of – the real world. If anything, the patent inapplicability of these assumptions to everyday experience, and the strongly interventionist policy views of most mainstream economists, suggests that actual markets do *not* co-ordinate the actions of buyers and sellers. Clearly, however, and despite massive and growing interference from governments, real-world markets do harmonise market participants' activities. We live not in a world of "market failure" but of pervasive government failure. Economists, their premises and models thus present investors with a perverse situation: investors seek to understand the beneficial and allegedly "counter-intuitive" real-world phenomena that are distrusted by economists, politicians and most members of the general public.

Blessed Be the Entrepreneur

An important strand of the Austrian School of economics, the Mises-Hayek-Rothbard theory of entrepreneurial discovery, has a much better explanation of how real-world markets work. Israel Kirzner, a student of Ludwig von Mises and for many years a

Professor of Economics at New York University, has extended and elaborated the theory and is perhaps its most prominent contemporary exponent (see in particular *Competition and Entrepreneurship*, University of Chicago Press, 1973, ISBN: 0226437752; *The Meaning of Market Process*, Routledge, 1996, ISBN: 0415137381; *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, Institute of Economic Affairs, 1997, ISBN: 0255364040; and *The Driving Force of the Market*, Routledge, 2000, ISBN: 0415228239). The Role of the Entrepreneur in the Economic System (the Inaugural John Bonython Lecture delivered by Kirzner at Adelaide on 30 July 1984) is an excellent five-page précis of this research. Investors could do far worse than to ponder and absorb its many important implications.

The theory of entrepreneurial discovery emphasises the very features of real-world markets that the mainstream's model of perfect competition excises. Most importantly, disequilibrium, not equilibrium, characterises the interactions among buyers and sellers; and disequilibrium (and its associated cycle of error, detection, correction and renewed error) underlies entrepreneurial activity and discovery. Markets do indeed tend towards market-clearing prices: but they never attain equilibrium because numerous events – the constant change of plans, discovery of new information and technology, commission of errors and their discovery and rectification – intrude. Alert entrepreneurs, be they producers, consumers or investors, detect errors and, through a process of trial and error, learn how they can be remedied. Occasionally, disequilibrium also enables prescient entrepreneurs to anticipate changes in others' plans and decisions.

Accordingly, movements of prices, changes of methods of production and distribution, and choice of outputs stem ultimately from changes in consumers' plans and desires; and entrepreneurial error, discovery and correction set these market forces in motion and influence them in directions that serve consumers' wishes. Alert and prescient entrepreneurs thus tend to reveal where and how the structure of production can be improved in order to serve consumers better. Entrepreneurial discovery is the oil that enables the market mechanism to operate and adapt so smoothly.

Note the gulf that separates the Mises-Hayek-Rothbard theory from the mainstream model of perfect competition. To mainstream economists, the decisions entailed by buying and selling in the market are mere mathematical derivations. A decision, in other words, is "made" by a "given" model, probability distribution and data. The mainstream model thus eliminates the real-life, flesh-and-blood decision-maker – the heart of the Mises-Hayek-Rothbard theory – from the market. Market automatons do not err; accordingly, it is unthinkable that an opportunity for pure profit is not instantly noticed and grasped. The mainstream economist, goes the revealing joke, does not take the $10 note lying on the floor because he believes that if it were really there then somebody would already have grabbed it.

In sharp contrast, Austrians recognise that decisions are taken by real people whose plans are imperfectly clear, indistinctly ranked, quite often internally-inconsistent and always subject to continual change. Further, at any given moment a market participant will be largely unaware of other market participants' present and future plans. It is participation in the market that makes buyers and sellers a bit more knowledgeable about their own plans and slightly less unaware of others' plans. Accordingly, they will inevitably make mistakes and not automatically notice them. It is not just possible – it is typical – that opportunities for gain ("pure profit") appear but are not instantly detected. Recognising the obvious – namely that he has possibly been the first to notice it – the Austrian School economist will therefore take the $10 note inadvertently dropped on the floor and ignored by his mainstream colleague.

An "Austrian School" act of entrepreneurial discovery, then, occurs when a market participant notices what others have overlooked. Warren Buffett discovered a lucrative opportunity (one of the first of many in his long and successful career) when he worked at Graham-Newman Corp. Mr Buffett recalls that "Rockwood & Co., a Brooklyn based chocolate products company of limited profitability, had adopted [Last In First Out] inventory valuation in 1941 when cocoa was selling for $0.50 per pound. In 1954, a temporary shortage of cocoa caused the price to soar to over $0.60. Consequently Rockwood wished to unload its valuable inventory quickly. But if the cocoa had simply been sold off, the company would have owed close to a 50% tax on the proceeds. The 1954 Tax Code came to the rescue. It contained an arcane provision that eliminated the tax otherwise due on LIFO profits if inventory was distributed to shareholders as part of a plan reducing the scope of a corporation's business. Rockwood decided to terminate one of its businesses, the sale of cocoa butter, and said 13 million pounds of its cocoa bean inventory was attributable to that activity. Accordingly, the company offered to repurchase its stock in exchange for the cocoa beans it no longer needed, paying 80 pounds of beans for each share. For several weeks I busily bought shares, sold beans, and made periodic stops at Schroeder Trust to exchange stock certificates for warehouse receipts. The profits were good and my only expense was subway tokens."

It is important to emphasise that this discovery, like Buffett's (and Benjamin Graham's) many others, did not derive from information that other buyers and sellers could not possess. These acts of entrepreneurial discovery stemmed from the alert analysis of publicly available information and the superior detection of opportunities that others had simply overlooked. On numerous occasions, in effect, Mssrs Buffett and Graham have known where to look and have been the first to detect the huge piles of $10 notes that others have disregarded and left lying on the floor. Anybody, for example, could also have bought parts of American Express, The Washington Post, GEICO and Coca-Cola when Mr Buffett did; but few saw what he saw and reasoned so clearly. Instead, most were distracted by myriad worries and irrelevancies, and so few followed Buffett's lead.

It bears repeating that the theory of entrepreneurial discovery recognises that market participants will be largely unaware of others' present and future plans, and therefore that they will inevitably make mistakes. This unawareness may take two general forms. The first is an error of commission (or of "undue optimism"). It occurs, for example, when sellers of a good expect buyers to be more eager to buy than they really are. A price that is too high to clear the market reveals that these sellers' expectation is mistaken. Disequilibrium prices signal to some market participants that their original plans will be disappointed and that revisions are therefore required. The change of price signals to market participants that the previous price was a disequilibrium price; and its reversion towards a market clearing level brings market participants' plans into greater harmony.

Unawareness of other market participants' present and future plans may also take the form of errors of omission (or of "undue pessimism"). Sellers, for example, may underestimate buyers' eagerness to buy; and buyers may underestimate the eagerness of sellers to sell. This type of unawareness generates more than one price for the same good. Errors of undue pessimism thus occur when opportunities are overlooked. Those paying the higher price do so simply because they are unaware that a lower price is available; those accepting the lower price do so because they are unaware of the higher price being paid. Such price differentials – whose existence, it is important to emphasise, mainstream economists routinely deny – provide opportunities for pure profit. Sooner or later, they tend to attract the attention of alert entrepreneurs; and their detection of these opportunities for profit will erode these price differences. Somebody, in other words – but presumably not the mainstream economist, who has been trained to discount or ignore the possibility that it exists – will eventually notice and take the $10 note lying on the floor. Until somebody does – until, in other words, the notion of entrepreneurial alertness and discovery is introduced, there is no endogenous basis for any change in a market situation.

Two Paradoxes of Entrepreneurship

Markets in the real world work so well, then, because alert entrepreneurs – that is to say, canny producers, savvy consumers and intelligent investors – detect and correct price discrepancies ("bargains"). The producer finds consumers who are prepared to pay a higher price for a particular good or service, and this opportunity exists until other producers also locate these consumers and offer a lower price. The consumer finds a producer prepared to offer a lower price than the consumer would have taken from other producers, and this opportunity continues until other consumers also discover the bargain and offer a higher price. Entrepreneurial discovery, and the opportunity for profit created by this discovery, is a powerful force pushing (for the sake of simplicity, let us say two) prices towards one another. This process eliminates price differentials and opportunities for profit, and thereby helps to coordinate buyers' and sellers' plans.

In a market economy – even one hobbled by vast and growing government interference – entrepreneurship plays a vital but paradoxical role. Contemporary mainstream economics can say little or nothing about entrepreneurship and opportunities for profit because they are unpredictable. Entrepreneurship is uncertain in the sense that one cannot "model" it with a particular probability distribution (although, trust them, some particularly silly mainstream economists have tried). Boldness, impulse, hunch and accident are the raw materials of human success and failure, and these passions and motivations render implausible the possibility that chains of human action will be remotely as determinate as the laws of natural and physical science.

In order to perceive regularities amidst the vagaries of real-world markets, it may at first glance seem sensible to imagine a world in which irregular things like entrepreneurship play no role. Yet, paradoxically, exactly the opposite is true: it is only when we acknowledge the critical importance of entrepreneurial discovery that we can appreciate how and why markets work. Without the possibility of entrepreneurship, no explanation – aside from the postulate that coordination always fully and instantaneously prevails, or that the government's agents somehow possess brains, information and morals that are above and beyond those available to benighted buyers and sellers – of coordination in the market is possible. To introduce the scope for entrepreneurial discovery is to emphasise the human liberty – and hence the ingenuity and folly – that enables errors to be committed, detected and corrected. It is ultimately on this basis of trial and error that civilisation advances.

Human error is as perennial as the grass. But unlike entrepreneurs, a government (or an entity privileged by government) has no incentive to detect and correct errors. In an unfettered market, errors are detected and rectified; but when governments supplant markets, errors are ignored and denied, and grow into problems, crises and eventually catastrophes (see in particular Thomas Sowell, *The Vision of the Anointed: Self-Congratulation as a Basis for Social Policy*, Basic Books, 1995, ISBN: 0465089941). In a market, competition among producers improves the quality of goods and services; and consumers reward good producers and punish the poor ones such that consumers and good producers prosper. In politics, however, the contest to hold the reins of power generates perverse results. Quality constantly declines and "innovations" occur only with respect to lying, cheating, manipulating, stealing and killing. The price of political services constantly increases and there is no obsolescence – planned or otherwise. In politics, as Friedrich Hayek demonstrated in *The Road to Serfdom*, "the worst get on top." The paradox for mainstream economists, then, is that one requires the "anarchy" (in the proper sense of that term) of entrepreneurship in order to explain the relatively smooth, systematic and peaceful character of real-world market processes.

As a result of market participants' reactions to unwarranted optimism and undue pessimism, not only will the prices of raw materials, capital goods and consumer goods and services constantly change: just as importantly, resources will tend to shift from less urgent uses (as measured by the prices consumers are prepared to pay) to more urgent uses; less productive technologies will be replaced by more productive technologies; and new technologies and new sources of materials will tend to be discovered. Motor cars, for example, will replace horses and buggies; assembly lines will replace slower and costlier means of assembling cars; new sources of coal and iron will be discovered; more productive means of mining coal and iron and of fabricating steel will be devised; and synthetic rubber will replace natural rubber. Each of these "discoveries" will stem from errors of commission and omission; and in each case entrepreneurs will detect and their responses will tend to attenuate these errors.

Whenever an entrepreneur moves from one line of production into another, or whenever she devises a new method of production or good or service – whenever, in other words, she senses the possibility of pure profit – she responds to what she believes is an erroneous assignment by market participants of two different prices to what is, in economic reality, exactly the same item. Accordingly, not only will the prices of existing goods and services tend towards equality throughout the market: the present value of today's capital assets and prices of resources will also tend towards equality (discounted by the rate of time preference) with future product prices. William Jevons's "Law of Indifference," in other words, which he introduced in *The Theory of Political Economy* (1871), subsumes the driving force of the real-world market. Hence the second paradox: the insights of the Austrian School – whose founder, after all, was a vital contributor to the neoclassical (Jevons-Marshall-Menger-Walras) synthesis of the 1870s – are required in order to explain phenomena that either escape the attention of, or utterly baffle, contemporary neoclassical (i.e., Walrasian) economists.

Equilibrium or Entrepreneurship: A Vital Distinction for Investors

William F. Buckley Jr. once remarked that he would sooner be governed by the first 2000 names in the Boston White Pages than by the 2000 members of the faculty of Harvard University. Similarly, I have much more respect for the views of self-made entrepreneurs than of Australia's most prominent economists and politicians. This is not because the former are unerringly insightful; it is because the latter are necessarily myopic and demonstrably self-serving (see in particular Henry Hazlitt, *The Failure of the New Economics: An Analysis of the Keynesian Fallacies*, Foundation for Economic Education, 1959, 1994, ISBN: 1572460024). When some economists and one or two politicians concede that the perfectly competitive market "works," they refer exclusively to a rarefied, abstract and never-never world, far removed from flesh-and-blood people and the gristle of everyday experience. They do not seriously intend that this model's assumptions explain phenomena such as the behaviour of buyers and sellers in real markets. Quite the contrary: they use the model to imply that real-world markets cannot and will not work and therefore that considerable and aggressive government intervention – guided, of course, by mainstream economists and policymakers – is required.

Hence a dangerous inferential leap: if the activities of individuals dovetail only when the stringent assumptions of the model of perfect competition prevail – which is never – then the real world requires a virtually omniscient, omnipotent and benevolent economic czar who is able to survey all endowments, preferences and potentialities. This real-world benevolent dictator must also devise and enforce a pattern of decision-making that coordinates all decisions. In a way he never intended, Adam Smith's "invisible hand" is an apt metaphor for what is, in effect, the analytical black box that mainstream economists have bequeathed to us. In two respects, then, contemporary economics as mainstream economists practice it resembles a debased and bastardised religion. First, matters that lie at its heart, such as market processes and dynamics, are dismissed via *ex cathedra* pronouncements as things that do not exist in this world (and in any case as matters beyond the flock's comprehension); and second, the grasping priesthood of economists and politicians seeks divine status (see in particular Robert H. Nelson, *Economics As Religion: From Samuelson to Chicago and Beyond*, Pennsylvania State University Press, 2001, ISBN: 0271020954).

In sharp contrast, the theory of entrepreneurial discovery shows how decentralised, individual-level plans and decisions in this world harmonise themselves into a reasonably – indeed, remarkably – coordinated state of affairs. The Austrian School theory explains why there is a powerful tendency – without any central direction or control – for transactions in the market to coordinate disparate individuals' myriad plans. It shows how real world markets work so well. It thereby does something that mainstream economists purport to do but never seriously intend to do.

How can these insights assist investors? Kevin Duffy, in an excellent article entitled Investing as an Entrepreneurial Endeavour, lists three ways:

1. *Seek cautious "business entrepreneurs" and avoid "political entrepreneurs."* Cautious business entrepreneurs incorporate healthy margins of safety into their decisions. They seek well-established businesses, reasonable valuations and solid financial statements. A rising tide, says Duffy, makes it more difficult to identify true entrepreneurs. Better, then, to wait for the tide's ebb – which exposes the market participants who, in Mr Buffett's words, have been "swimming without a bathing suit." Above all, avoid the political entrepreneurs (Enron Corp. springs to mind) who, in Duffy's words, "attempt to circumvent the whims of the consumer and the vagaries of the competitive marketplace by convincing government to grant them some sort of privilege or protection."
2. *When looking for investment opportunities, stand apart from the crowd.* Mr Buffett once told his shareholders "correctly observing that the market was frequently efficient, [the efficient markets enthusiasts] went on to conclude incorrectly that the market was always efficient. The difference between the propositions is night and day." Price and value, in short, are not synonyms; and sometimes the one deviates sufficiently from the other such that an investment operation can be

undertaken with a reasonable margin of safety. But for neither lemmings nor people does safety reside in the crowd. An investor does not need a crystal ball or a "consensus view" to prosper: he needs valid and reliable information, an ability to reason soundly and a calm and patient temperament.

3. *Avoid the crowd's mainstream economic follies.* The typical investor is unaware that the central bank's creation of credit not backed by savings creates artificial booms; that the trouble with booms is that, sooner or later, they are followed by busts; that busts are salutary phenomena because they liquidate the "malinvestments" that fuelled the artificial boom; and that despite governments' efforts to prove otherwise, the laws of economics ultimately prevail. Perhaps the typical investor is unaware of these things because mainstream economists and politicians are either oblivious to them or relentlessly obscure them.

The fundamental lesson for market participants, i.e., buyers and sellers, producers and consumers, borrowers and lenders – and above all business owners, capitalists and investors – is that real-world markets really do work. The theory of entrepreneurial discovery explains how they work; and the less the meddling from economists and politicians, the better they will work. Best of all, the benefits of voluntary exchange are moral as well as empirical. The great British pamphleteer of laissez-faire capitalism, Richard Cobden, therefore has the last word: "I see in the [principle of voluntary exchange and free trade] that which shall act on the moral world as the principle of gravitation in the universe, drawing men together, thrusting aside this antagonism of race, creed, and language, and uniting us in the bonds of eternal peace."