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WEALTH MANAGEMENT

PREDICTABILITY OF THE FUTURE - PART 2

Personal Investing Series

Article 3

In Predictability of the Future – Part 1 I talked about investors trying to profit from their predictions about the future. I argued that the most likely result would be reduced returns due to increased transaction costs and taxes. The question for this article is the following: if the average investor is unable to profit from predictions on the future, is it possible for a savvy investment pro to do so on your behalf?

Remember from the last article, I proposed that the only way to profit from knowledge about the future was 1) to have knowledge before anyone else and 2) to act upon that knowledge before anyone else.

There has been a raging debate for the past few decades regarding something called “efficient markets”. The idea of efficient markets is that securities (stocks and bonds) are always priced fairly based upon all the information that is known about a given security at a given point in time. Consequently it is not possible for an investor, amateur or professional, to outperform, except by chance.

In my opinion, the markets are not 100% efficient and the professional investor perhaps can, on occasion, profit from “knowledge”. However, the securities markets are immensely complex and ever changing. I am doubtful that any one person, group of people, or trading system can consistently have “knowledge” that others do not have. This is controversial! A great many people will strongly disagree with me. The focus of my point here is being able to profit consistently. Here is why I am skeptical.

Observation 1. After 20 years of working on Wall Street in New York City, I have developed a very healthy respect for how incredibly complex the markets are. They are so complex that at any point in time you can find respected and knowledgeable market pundits advocating predictions in every direction imaginable. (Also if you read their predictions carefully, many pundits couch their predictions in such vague language that they can be used as proof of their expertise no matter what the markets do later.)

Observation 2. I have seen and read about many trading systems designed to predict price movements. Some are simplistic. An example is the Dogs of the Dow Theory, which says to buy the least attractive stocks (the dogs) out of the 30 stocks that make up the Dow Jones Industrial Average at the beginning of each year. Some trading systems are based on very elaborate computer models. An example of this is the hedge fund manager, Long Term Capital, which lost 90% of its clients’ money in 1998.

Some trading systems are based upon circumstantial evidence. An example of this is if an original NFC team wins the Super Bowl, the market will be up that year. Other trading systems appear to hold up under rigorous scrutiny but fail when put into practice. A good example of this is the well regarded Valueline Survey. Valueline has a ranking system for a universe of about 1700 stocks. Valueline has kept track of the performance of their rankings over time. A portfolio of their best ranked stocks has consistently outperformed the next best level, which outperformed the next level, and on down the line for each of the five rankings. Their paper track record is truly phenomenal. Eventually Valueline had the idea to sponsor a mutual fund that would trade on their rankings of stocks. Guess what? The fund didn't perform anywhere near as well as the paper rankings did. The reasons are transaction costs, bid-ask spreads, trading illiquidity, and lots of other investment jargon that is nonetheless critical when translating a trading system into real profits.

Observation 3. Active managers, who trade securities actively in an effort to beat the market, tend to do just the opposite. As you have probably heard before, index funds, which are designed to match the market, beat as much as 70% of the active managers in any given year. This is before tax considerations. On an after tax basis, the comparison is even worse. If investment pros can consistently predict the future in regards to which securities to own and which to not own, then why do they tend to under perform?

Observation 4. There is always someone out there who seems to defy the odds. They have track records that suggest they can beat the system. Peter Lynch, formerly portfolio manager of Fidelity's Magellan Fund is one. Another is Warren Buffett, chairman of Berkshire Hathaway. Maybe these guys really do know something, maybe they were lucky. I don't know. I do know that there are precious few reputations of this caliber.

My statistics professor once suggested the following theoretical experiment. Take a 1,000 people, line them all up, gave each a quarter, and ask them to flip the coin. Each person who gets heads gets to stay in line. Everyone else is out. After 10 flips, statistically you should have one person left. That is to say, statistics would predict that one person out of a thousand would have come up heads 10 times in a row. What my cynical professor then said was that there would be a mob surrounding this randomly lucky guy asking his advice on how to flip coins.

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