

Market timing, a little more on stock selection and guess-the-weight

In a recent article I argued that the euphoria around green shoots was misleading and that we far from “out of the woods”. Since then international stock markets have rallied further with FTSE 100 as I write likely to produce a record breaking quarter.

Does this mean we are out of the woods? Instead of theorizing, how should investors react? Should we perhaps take money out of stocks and shares because the prices are now too high? I hope the following helps to re-explain how academics, institutional investors and Hillier Hopkins behave in these still difficult times.

To start with, no we are very far from out of the woods. The inflation picture remains confused. UK inflation has not fallen by anything like as much as was expected. As the Bank of England Monetary Policy Committee note in the minutes of their September meeting “..CPI inflation excluding the contributions of food and energy prices had remained stubbornly high...”, the money supply as measured by M4 has not grown by anything like the target rate 6% - 9% and the picture on unemployment and GDP remains grim. But what does this lead us to do for clients? Should we buy equities because the stockmarket is a leading indicator? Should we sell equities because rises are inevitably followed by falls? The answer to both of the last two questions is “No”. Academic research from the 50s repeated and refined again and again demonstrates that one cannot time the market. Timing the market is what most actively managed funds, particularly the criminally mistitled “Balanced Managed Funds” attempt to achieve. Brinson, Hood and Beebower published research in 1986 based on pension fund data. They concluded that tactical asset allocation (or market timing) accounted for a tiny percentage of total return volatility but that strategic asset allocation accounted for 96.7%. Their paper was much criticised and updated with further data in 1991 – this time strategic asset allocation accounted for 91.5% of return volatility. It is the mix of assets and staying invested that is hugely more important than the popular pastimes of market timing and stock selection.

But Brinson et al's paper was not the first. Jensen's 1968 paper “The Performance of Mutual Funds in the Period 1945 – 64” studies fund manager performance. He concluded that no mutual fund manager was able to use timing abilities to add value over the long term. Mark Carhart looked at data from the 1960s to the 1990s – again broadly the same conclusion. I could argue that Adam Smith was arguing for the Efficient Market Hypothesis.

Of course there are other points of view. But the weight of academic evidence is huge.

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Customers believe that the primary job of stockbrokers and fund managers is to pick the right stocks and to anticipate market moves – the sad evidence is that no one can do this successfully in a statistically significant way and be identified in advance. And since fund managers and stockbrokers and their support teams need to be paid, and since trading stocks at all creates costs, the net (post expense) results for clients are typically very poor.

Trying to get in and out of markets or stocks increases rather than reduces risk and increases expenses very substantially.

Eugene Fama wrote his thesis on the Efficient Market Hypothesis in the 60s and together with Ken French wrote the most compelling papers on the size effect and the value effect. Essentially, the expected return for an investor on small stocks is higher than the market average and the expected return on value stocks is higher than the market average. While these pioneers of investment theory wrote the PhD papers that are referenced most commonly, other theorists had already postulated that value investing worked and that large groups of market participants tended to price in all known information into the price of a good in a free market. The father of value investing was Benjamin Graham. His book *The Intelligent Investor* was published in 1949. He was one of Warren Buffet's mentors.

I am grateful to my friend and competitor Simon Brown for the following story which starts in 1906.

The Wisdom of Crowds

In 1906 the British scientist Francis Galton left home in Plymouth and headed for the annual West of England Stock and Poultry Exhibition where local people gathered to appraise the quality of each others' cattle, sheep, chicken, horses and pigs. Galton was 85 and was renowned for his work on statistics and the science of heredity.

Breeding mattered to Galton as he believed that only a very few people had the characteristics necessary to keep societies healthy. His experiments left him with little faith in the intelligence of the average person. Only if power and control stayed in the hands of the select well-bred few, Galton believed, could society remain healthy and strong.

As he walked through the crowds he came across an ox-weighing competition where the punters had to guess the weight of the ox once it had been "slaughtered and dressed". Eight hundred people tried their luck. They were a diverse lot. Many of them butchers and farmers, who were presumably expert at judging the weight of livestock, but there were also quite a few people who had, as it were, no insider knowledge of cattle. "Many non-experts competed," Galton wrote later in the scientific journal nature, "like those clerk and others who have no expert knowledge of horses, but bet on races, guided by newspapers, friends and their own fancies." Galton further wrote, "The average competitor was probably as well fitted for making a just estimate of the dressed weight of the ox as an average voter is of judging the merits of most political issues on which he votes".

Galton was interested in figuring out what the "average voter" was capable of because he wanted to prove the average voter was capable of very little. When the competition was over he borrowed the tickets and ran a series of statistical tests. One of the tests was to add up all the estimates and calculate the mean of the group's guesses to obtain the collective wisdom of the Plymouth crowd. Galton undoubtedly thought the group would be way off the mark; after all if you mix a few smart people with some mediocre people and a lot of stupid people it seems likely that you'd end up with a stupid answer.

He was amazed to see that the crowd had guessed the weight of the ox at 1,197 pounds. After slaughter and dressing it actually weighed 1,198 pounds. "Perhaps breeding did not mean so much after all", Galton wrote later. "The result seems more creditable to the trustworthiness of a democratic judgment than might have been expected".

What Galton stumbled on that day is a simple but powerful truth that under the right circumstances, groups are remarkably intelligent and are often smarter than the smartest people around. This belief is at the heart of our passive asset class investment strategy. We believe markets work and are incredibly efficient at determining the best price of an asset based on all available information. Hillier Hopkins believe that we are not smarter than the millions of market participants and that we should concentrate on a disciplined investment strategy taking risks that will be rewarded in the long term, dispassionately rebalancing and accepting asset class returns whilst keeping investment and dealing costs to a minimum. These fundamental principles when applied without emotion are the starting point of "winning the losers game".

Markets are generally efficient for investment purposes. If there were a way of predicting the movement then the market would realise this and returns would have to drop. If returns dropped there would be no risk premium, so investors would have no reason to invest.

So what to do?

Acknowledge that investing in equities and property is risky.

The risk of investing in the wrong company can be reduced using diversification. So invest in lots of companies

The risk of investing in the wrong sector can be reduced using diversification. So invest in many sectors.

The risk of investing in the wrong country can be reduced using diversification. So invest globally.

There are a few fancier things that we can do to do with investment theories and correlation and rebalancing but

Acknowledge that investment risk cannot be eliminated

If it could be eliminated the risk premium would also be eliminated.

Ensure that you have enough cash never to be a forced seller.

If none of this is very comforting also acknowledge that over time, the range of possible outcomes seems to decrease; it has done historically. The one year outcomes for a typical HHLLP portfolio over the last twenty years range between +28.2% and -19.0%. The five year returns vary between 2.9% per annum and 14.6% per annum and so on. I have to be careful of how we use these numbers – averages always lie within outliers by definition – but the resilience of these numbers is reassuring.

Conclusion

Stay invested. If your goals change, if your tolerance of volatility or losses change or if you have a new cashflow requirement then consider adjusting the long term makeup of your portfolio. Otherwise invest and rebalance (though not too often), keep an eye on taxes, expenses and new ideas but stay healthily sceptical, and stay unemotional. Expect your portfolio to lose money from time to time. Something would be wrong if it did not lose money from time to time. Portfolio design and management is not a discrete job that can be done and ticked off when complete. It is a circular process.

Benjamin Graham was a remarkable investor who greatly influenced Warren Buffet. I will finish with a few of his quotations:-

"The Investor's chief problem – and even his worst enemy – is likely to be himself"

"Wall Street people learn nothing and forget everything"

"Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed"

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I have not mentioned him but do not forget the Nobel Laureate William Sharpe who demonstrated that even if there was a tiny bit of theoretical outperformance from a star manager the extra costs involved would reduce the return to below market.

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