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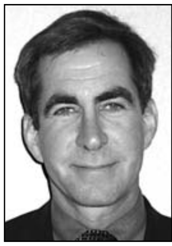
Beating the market

"Should I be paying an expert to pick stocks and mutual funds that beat the market?" If you have ever asked yourself this question, this column's for you.



Personal Finance

By Allan Roth
Business Journal Columnist

Most of us know a money manager who claims to consistently beat the market. No doubt some have done just that over time.

Let's examine how professionals perform. We've all seen that most mutual funds underperform the index they are being paid to beat. There are some money managers, however, who do seem to beat the market on a consistent basis. Just imagine how rich we could become by asking the best money managers what their favorite stocks are and building a portfolio of those stocks.

Well, Money Magazine, in its October 2003 edition, provided this service for its readers. They selected 24 top money managers they called "the ultimate investment club" and asked them to select their best stocks. The 24 experts selected 34 stocks traded on U.S. exchanges.

Each of their selections was backed by brilliant and compelling logic. For example, one guru stated he was a devotee of United Online (UNTD), a low-cost Internet service provider. He stated "United offers Web access at around $9.95 vs. $23.95 from leader America Online." Noting that the company was gaining market share, he stated that United Online could be the Wal-Mart of the business. Wow – this could have been like having a second chance to buy a Wal-Mart before it became big!

Let's see how the portfolio of 34 stocks performed over the next year. Would we have become rich? Well, not exactly - the stock portfolio returned an average of minus 2.4 percent, while the U.S. stock market earned a positive 11.5 percent. In other words, the value added of the best these top gurus had to offer was nearly a negative 14 percent during the next year. Blind folded chimps picking stocks by throwing darts at the financial pages would have trounced the pros! Could it be the emperor has no clothes?

How did United Online perform? It lost 62 percent! While the logic might have been brilliant and compelling, every other guru also knew AOL's price and the fact that it was losing market share to companies like United. Accordingly, this information already was priced into both companies. In fact, during the next year, AOL's parent, Time Warner, beat United's performance by 62 percent while AOL lost market share to United.

There are two important lessons from this illustration.

1. Following the advice of proven professionals and their brilliant and compelling logic does not mean you will beat the stock market. In fact, following the experts may leave you feeling like a country western song – you start the relationship with big hopes and dreams but all you end up with is a broken heart and a bunch of dogs.

2. Building a diversified portfolio cannot be accomplished with only 34 stocks, as witnessed by a 14 percent variation form the market. If you prefer gambling to investing, putting all of your eggs in a few dozen stocks should provide you with some of the thrills of Las Vegas.

I know you are probably saying to yourselves that I'm basing these two lessons on only one example, and you would be absolutely right. However, there exist countless statistically valid studies that demonstrate the same points, but even a summary of results wouldn't fit in any sized newspaper. And while it's true that some professionals do beat the stock market over long periods of time, it may be that their numbers are fewer than random variation (otherwise known as luck) would have predicted. The phenomenon of past high performing stock pickers suddenly becoming average is known as "regression to the mean." It's almost irresistible, however, to stop chasing the "hot hand" even though we know past performance usually has nothing to do with future returns.

The inability of experts to beat the market is not limited to stocks. It's true for bonds as well. The Wall Street Journal Semiannual Economic Forecasting Survey of the nation's top economists has forecasted the direction of long-term interest rates correctly only 29 percent of the time, according to Bianco Research LLC. This means you likely would have been better off flipping a coin than relying upon the combined wisdom of the best economists. Of course, you'd be even better off not relying at all on timing interest rates.

What does this mean to you, the investor? It means that paying an expert to pick winning stocks and mutual funds is likely to increase both your costs and risks, while decreasing your return. Don't do it! Building a portfolio with boring products such as ultra low cost and diversified index funds and exchange traded funds is far more likely to yield a greater return. Albert Einstein called the power of compounding the most powerful force in the universe, and low-cost diversified investing is far more likely to build wealth than following the hot hand or our emotional instincts.

In future columns, I will write about constructing simple portfolios that will match your willingness and need to take risk with products that are more likely to build wealth for you and achieve your financial goals.

In conclusion, I am fully aware this advice will not make for exciting discussion at any investment club. I do, however, ask you to keep reading this column with an open mind. In return, I'll show you a better way to invest that may double your real return. Now that could be exciting!

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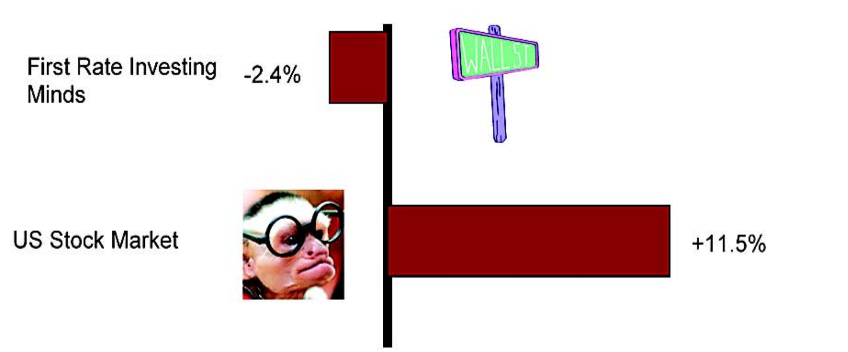
Disclaimer: These are views of the writer and are believed to be accurate. They are not intended to be specific investment advice which requires understanding the reader's individual circumstances and goals. The reader is encouraged to seek advice from a qualified financial professional.

How did the Ultimate Investment Club perform over the next year? They destroyed 14% vs. the Market!



Twelve months ended August 31, 2004. Source: Calculated from Yahoo Finance - included dividend reinvestment. This included six stock picks listed on US exchanges but not included in the Wilshire 5000 Total Stock Index. **The 28 US domiciled stocks had a -7.6% return which lagged the index by 19%. This 19% differential is the more appropriate comparison.**

As this chart shows, not even the experts can beat the market.