

CHAPTER 1**Can You Beat
the Market?**

The speculator's edge • traits needed for an edge • the right stuff • markets need speculators • lending a helping hand • fair value • market mistakes • uncovering mistakes • corporate profits and fair value • statistical models for profit forecasting • such models are useless • investors don't live in Lake Wobegon • evidence from mutual fund performance • technical analysis and market timing won't give you an edge • the catch-22 of investing • the No Free Lunch principle • the art of speculation • most people should not speculate • but if you have the right stuff, read on!

THE SPECULATOR'S EDGE

Can you beat the market? I'm going to do my best to convince you that the answer to this question is *no*. This surely is a novel way to start a book about speculation! Of course the name of the speculative game is beating the market. And, yes, I want you to read this book about beating the market from cover to cover and tell all your friends to do the same. But I also want you to read these chapters with your eyes wide open to the dangers and pitfalls of speculation. There is no easy money waiting for you in the financial markets. So here, right up front, is the most important thing I have to say to you: *Don't speculate unless you are sure you have an edge. Without an edge you can't beat the market.*

What do I mean by an edge? An edge is a talent or skill or some specific knowledge that will give you an advantage over other investors and

speculators. Sad to say, a high IQ, great educational credentials, or a substantial net worth are *not* edges in the game of speculation. Neither is the willingness to work hard and to keep trying after repeated failures. These things may make you a success in your profession or trade and a valued member of your community. But they won't guarantee you success in the world of speculation.

You should know that the biggest part of any speculator's edge does *not* come from a superior scientific or statistical knowledge of market behavior. If it did, you could build your edge the same way you acquire skills in any profession—by study and practice. But have you noticed that no college or university offers a major in speculation? There is a good reason for this. A speculator's edge arises from two personal traits that can't be taught and that people either have or don't have. The first is flexibility of mind and spirit, the ability to adapt easily and quickly to changes in market conditions and habits. The second is the willingness to think for oneself and to risk hard-earned money by “fading” (investing opposite to) popular opinion. This means that you will usually take market positions that most people (your husband or wife especially!) will see as unwise or even foolish. Doing this day in and day out requires emotional toughness that few people can muster. It also requires a certain arrogance—a firm conviction that you know what you are doing and that most other people in the market don't. Do you have the right stuff to be a successful speculator?

I think you will agree that this is an unusual explanation of the nature of the speculator's edge. In our technological society, it's natural for people to believe that speculative profits arise from the use of superior methods or from some arcane knowledge of market behavior. But this isn't true. The essence of successful speculation cannot be found in specialized knowledge of market behavior or of trading technique. You can't learn to be a successful speculator by reading books (this one included!), by taking courses, or by attending seminars.

However, if you do have the right stuff to be a speculator, then you can move your game to a higher level by applying the methods I explain in the following chapters. The financial markets need skilled speculators. Capitalism couldn't survive without them. To see why, just keep reading.

LENDING A HELPING HAND TO INVESTORS

What is a speculator? What is his mission on capitalism's battlefield of creative destruction? Lewis and Short (my always-at-hand Latin dictionary)

defines the verb *speculator* to mean “the action of watching, observing, examining or exploring.” So a speculator is a lookout, a scout, an explorer, and an investigator.

A financial speculator explores the terrain ahead of the army of long-term investors. This army is advancing toward a very uncertain future, a consequence of Joseph Schumpeter’s perennial *gale of creative destruction*, which always accompanies the development of a capitalist economy. Long-term investors must be assured of being able to buy and sell at a *fair price*, and this despite the enormous uncertainty that is in capitalism’s very nature. If long-term investors believe that markets won’t give them a fair shake, they will lock up their investment capital, and the machinery of capitalism would then grind to an impoverishing halt.

How does a speculator help ensure that long-term investors get a fair shake? Every speculator is on the lookout for mistakes the market has made in pricing a stock, bond, or commodity. A market mistake is a situation where the current market fails to accurately reflect all that is known about the probable earning power of the company or the supply-demand balance for the commodity. A speculator profits by spotting market mistakes and helping to correct them by buying when the price is too low and selling when it is too high.

A market mistake is a deviation from the *fair value price*. The phrase *fair value* is a plain-and-simple term for what economists call the *equilibrium price* (i.e., the price that will equate supply with demand). Economics teaches that the equilibrium price is an accurate reflection of what is known about the prospects of the stock or commodity in question. As such, the equilibrium price is a very good thing. People who buy or sell at the equilibrium price are getting a fair shake; they aren’t being unfairly exploited by more knowledgeable investors.

It is important to remember that the concept of fair value can be difficult to pin down. In the next chapter we briefly discuss one method for calculating fair value: *discounted future dividends*. In Chapter 5 we discuss another: the *q ratio*, first developed by the economist James Tobin. Both of these methods are designed to give very long-term, multiyear estimates of the fair value price. But generally both methods are too unwieldy to be of much use to a professional speculator. We discuss more practical ways to estimate fair value in Chapter 6.

It should come as no surprise that markets make mistakes. Usually these mistakes are only short-lived, minor ones, but on occasion a market makes a really big, long-lasting mistake. Mistakes can take the form of a shortsighted reaction to a surprising corporate or economic development. Or a mistake can arise because of a mass delusion or mania. In either case, the price of the stock or commodity rises too high or falls too low relative to any reasonable assessment of fair value.

A speculator's economic function is to be on the lookout for these market mistakes and to help correct them. He does this by buying when the price is below fair value and by selling when it is above. The speculator's buying and selling thus helps to nudge the market price closer to fair value. In this way speculators perform a valuable service for longer-term investors. They help ensure that market prices more often and more closely reflect the best possible assessment of future economic prospects.

UNCOVERING MARKET MISTAKES

How does a speculator know that the market is making a mistake? You can be sure that there is no neon sign to that effect posted in front of the stock exchange. You won't see "XYZ ON SALE TODAY" or "ABC NOT WORTH AN ARM AND A LEG" running across the message board at 42nd and Broadway in New York City.

Most investors approach the problem of identifying market mistakes from an economic and statistical perspective. Basic economic considerations suggest that the fair value price for a company's stock should be determined by discounting to the present the profits the company is likely to earn over some reasonable time interval, say 10 years. You can try to estimate of these profits by modeling the industry and the economy using state-of-the-art statistical and economic tools. Or you could buy this information from someone who can do this modeling for you. In either case this profit estimate will determine an estimate of the fair value price for the stock. Detecting a market mistake is then just a matter of comparing this estimate of the fair value price with the current market price.

This certainly is a logical approach to the problem of uncovering market mistakes, at least in the stock market. Economists agree that the fair value for a corporation's common stock is the price that reflects all the information currently available about the company's future earning power, dividends, general economic conditions—everything that might be relevant to estimating the likely future dividends and capital gains an investor could expect. Investors who adopt this approach will purchase stocks that are trading below their estimates of fair value and sell stocks if they are trading above such estimates. Here is the key question: Is there any reason to believe that this method for detecting market mistakes will allow an investor to earn above-average returns?

You may find my answer to this question shocking. I believe that it is *impossible* to earn above-average returns on your investment portfolio by using statistical estimates of economic fair value. Why? Well, the key phrase is *above-average returns*. One can certainly use statistical and

business knowledge to construct models for estimating fair value of a common stock that have some reliability. But you must keep in mind that speculation is a very competitive business. Many investors, money managers, and economic consultants are doing this same thing. They are all competing for the profits that can be earned by making superior estimates of a stock's fair value price.

Sadly, unlike the children of Lake Wobegon, who are all above average, investors cannot all achieve above-average investment results. Remember that lots of people have the knowledge and statistical skills to build good corporate earnings forecasting models. If building such models led to superior investment results, people would rush in and adopt this methodology. But by doing so they would collectively move market prices in the direction of their fair value estimates. This would narrow the deviation of the market price from the fair value estimates to the point where this investment technique would yield only average results. There is so much competition among model builders and the investors who pay for these models' forecasts that neither group can earn above-average returns, either by building models or by using the forecasts the models produce to guide their investment strategy!

LOOKING AT THE EVIDENCE

Perhaps I have already convinced you that competition makes it hard to speculate successfully by doing corporate profit modeling. But if not, you might counter by saying that the world in which we live is nothing like the freely competitive world of theoretical economics. Perhaps all that is needed is to build the better mousetrap, the super-duper, high-tech profit-forecasting model that will beat all others to the pot of gold. I think there is very good reason to be skeptical of this possibility. If resources and technical skills would guarantee success in the battle for investment profits, we should find that investment professionals, those who ought to have access to the best profit-forecasting models, produce better than average investment results. So let's look at the actual investment results achieved by professional money managers to see if this is true.

In a 2005 article in the *Financial Review*, "Reflections on the Efficient Market Hypothesis: 30 Years Later," volume 40, pp. 1–9, Burton Malkiel examined the performance of professional money managers in the United States and other developed countries. His data on mutual fund performance reveal three important facts. First, most actively managed stock market mutual funds underperform their benchmark index, the Standard & Poor's (S&P) 500. Over a single-year time span, 73 percent do worse than

the index, and this percentage increases to 90 percent if one considers performance over a 20-year time span. Second, passively managed S&P 500 index funds do about 2 percent better per year than do actively managed stock market mutual funds. Most of this difference is accounted for by the higher fees actively managed mutual funds charge their shareholders. Finally, there is little consistency from year to year in performance relative to the benchmark by any given mutual fund. So it is impossible to tell in advance which mutual funds will do better than the benchmark using only their past performance as a guide.

Malkiel's conclusions are typical of those reached by financial economists when they examine the performances of professional money managers. From this body of research I think we must conclude that models that estimate fair value using economic and business data will *not* give you any advantage over other investors. If they did, we would expect to see above-average investment performance by stock market mutual funds, because their managers have access to the best earnings forecast models. We would also expect such market-beating performance to persist from year to year for specific mutual funds, because it is the mutual fund management firm that pays for the models and these models would be available to any manager who works for the management firm.

But we see none of these things. The conclusion to be drawn from this evidence is simple enough. If you are trying to identify the market's mistakes by using statistical models to estimate future profits, you are barking up the wrong tree. Models that forecast corporate profits can't help you beat the market, because everyone uses them. After all, this sort of approach to stock market valuation is taught in every business school. How could it give you a chance to earn above-average returns if every professional money manager knows and uses it?

MARKET TIMING

There is an even more striking conclusion to be drawn from the persistent underperformance of mutual fund money managers as a group. The logic that leads one to conclude that statistical forecasting models that forecast corporate profits can't be used to achieve market-beating investment performance has to apply to other approaches as well.

This broader category of essentially valueless methodologies includes what are popularly known as technical analysis and market timing. The idea behind technical analysis is that a market's price action reveals to the careful observer what other investors have learned about fair value. For example, investors who estimate fair value using economic and business

data (so-called fundamentalist investors) reveal these estimates to the watchful and skilled market technician via the buying and selling they do to take advantage of their models' estimates. In this way a market technician believes he can piggyback his analysis upon the efforts of the fundamentalist investors. When he does this, he amplifies the effects of fundamentalists' buy and sell decisions.

In the standard technical analyst tool kit one finds various forms of price chart interpretation, momentum and moving average trading strategies, and overbought-oversold oscillator methods. These tools are too widely known and studied to help you earn above-average returns on your investments. Any advantage they might confer is soon competed away in the profit-seeking rush of technical analysts to adopt them. Of course one cannot rule out the possibility that there *are* market-beating technical methods. One can only deduce that you will not read about them in a book!

A market timer is someone who attempts to beat the market by predicting the swings in market prices ahead of time and acting on these predictions. Technical analysis typically plays a big role in most market timers' decision processes. But market timing is in general a fruitless activity for the same reason that technical analysis fails.

Think about market timing like this. If a market timer is to be successful he must be right twice in a row—he must first buy low and then sell high. So let's suppose our hypothetical market timer is quite skilled and has developed a method that predicts and takes advantage of the direction of a market's upcoming move 70 percent of the time (most methods I have seen don't come close to this success rate). The probability that this market timer is right two consecutive times is $.70 \times .70 = .49$. So even if his method guesses right 70 percent of the time, only 49 percent of the time will he improve his position over the alternative of doing nothing. For this reason the odds are that a market timer's efforts will simply make his portfolio more volatile without increasing his average returns. Even a skilled market timer will have difficulty beating the market.

CATCH-22

We have just encountered what I call the catch-22 of investing: Any statistical methodology that directly (fundamentalist approach) or indirectly (technical analysis approach) estimates fair value and that is widely used cannot help you beat the market. Economists call this the *No Free Lunch principle*. Competition among investors leads to a situation in which knowledge in the public domain can't lead to above-average investment returns. There is no information you can find in a book on investing or trading

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THE ART OF CONTRARIAN TRADING

(this one included!) or you can learn at an investment seminar that will by itself help you do better than the market. Notice that this also means that it is even impossible for you, an average investor, to purchase superior investment performance by entrusting your money to a professional money manager.

So where does the No Free Lunch principle leave us? One thing seems obvious. Developing an edge over other investors cannot simply be a matter of reading some books, getting a good education, or having a high IQ. An edge cannot arise from mastery of statistical and analytical skills you can learn from books or in business school courses. The reason is simple: Lots of people do this, and what lots of people do won't make you an above-average investor.

I think that to develop an edge you must start by abandoning preconceived ideas. You are making a good start if you have read this far. You must learn to be suspicious of popular opinion and conventional wisdom. Indeed, the entire art of speculation consists of choosing the right moment to invest in a way opposite to that suggested by popular opinion. An edge can be found only by living by one's wits in a world where survival and prosperity are daily question marks. I have seen firsthand that maintaining this kind of edge extracts an emotional and mental toll that very few people can pay. For the vast majority, an investment edge is just not worth the effort it takes to acquire and maintain it. It makes no sense for most people to speculate in the financial markets.

Well, I have done my best to convince you that you should not speculate. But if you still think you have the right stuff, you will find a lot of useful information and suggestions in the rest of this book. I'll try to explain what you must do to hone your speculative skills. I can summarize my message very simply: Become a professional contrarian!