ROCHESTER BUSINESS JOURNAL
RBJ
VOLUME 30, NUMBER 33 WWW.RBJDAILY.COM NOVEMBER 14, 2014

Break free from the traps of the investment world

ON INVESTING
Mark Armbruster

Question: What do you call an economist with a forecast?

Answer: Wrong.

We are constantly inundated with forecasts from "the experts." This is true not only from economists, but also from political pundits, Fed watchers, stock market strategists and other prognosticators. It is fun to watch and consider the soothsayers' predictions, but is there any actual value to their prognostications?

Take the example of Nouriel Roubini, a professor of economics at the New York University Stern School of Business. He is a well-respected author, educator and economist who correctly called the collapse of the housing market in 2008, as well as the subsequent global recession. Clearly, given his experience and credentials, he is well positioned to make prescient forecasts. However, in the years following the 2008 crisis, Roubini continued to warn of further economic calamity, all while the economy rebounded and the stock market rose to record highs.

Back when I worked on Wall Street, I saw this first hand. Stock strategists at various firms would rise to prominence based on a correct market call, but would then fall out of favor when they missed the next big event. I started to wonder if this wasn't akin to a stopped clock being right twice per day.

It turns out my observation wasn't a new one, nor was it unique to the field of investing. Philip Tetlock, currently a professor at the University of Pennsylvania, had been studying this phenomenon for some time. He studied predictions from 284 different experts across several disciplines. He tracked their forecasts for more than 20 years and had a database of 82,361 predictions to study. The result: The experts are not right very often. In fact, they were correct in their forecasts less than you would expect from random chance.

The reasons why experts are wrong so often are varied, but overconfidence is a big part of it. Because experts believe that they are experts, they tend to minimize any evidence that disproves their theories. This is called confirmation bias by behavioral economists. Besides, most pundits are not ever held accountable for their forecasts, so there is no real downside to making bold proclamations. While that may be fine for political and economic seers, it can be more damaging in the investment industry, where real money is at stake.

Unfortunately, the evidence of skillful forecasting in the investment industry is no better than in other industries. A study by CXO Advisory Group looked at 6,000 forecasts by investment experts and found an accuracy rate of only 47 percent—again, worse than you could expect from merely flipping a coin.

This results in significant opportunity cost across different sectors of the economy. Academic studies show that many large pension fund managers and endowment fund managers lag the returns of the stock market over time, despite having access to the best deals. The professionals that run mutual funds fare even worse. Over longer periods, the evidence shows that roughly 80 percent of domestic stock fund managers underperform their benchmarks, despite being managed by smart, educated, experienced people with the best resources and technology.

So, if the experts can't get it right, what hope do individual investors have? Actually, I believe that individual investors have some advantages over the pros.

First, they can keep things simple. In our world of derivatives, hedge funds and other complex products and strategies, there is still a lot of evidence that simpler is better. A study in 2007 by professor Victor DeMiguel from the London Business School looked at 14 different models used to optimize portfolio construction. What he found was that none of them were any better than just equally weighting all the investment choices. Unlike the pros, who need to justify their decisions with analytical tools, individuals can use simple, intuitive approaches to investing, which usually end up providing stronger returns, particularly after costs and taxes are factored in.

Next, individual investors can take a long-term approach to investing. There have been many studies over the years showing that long-term investment approaches provide higher returns. The pros have to report their performance over shorter intervals and are held accountable for performance shortfalls. Accordingly, they are apt to make decisions that maximize short-term gains, but that are not necessarily the best in the long run. Individual investors can be much more patient about their investment strategies, which is likely to benefit them over time.

Individuals can also tune out the "noise" of the investment world since they don't answer to clients or investment committees. There is a lot of pressure on the pros to react to short-term market and economic forces. However, reacting to short-term events usually just increases the amount of investment costs and potentially results in taxable events, both of which can erode net investment returns.

Finally, individuals don't have to window dress or put on appearances. Because they do not have to disclose positions or answer to anyone, individuals do not have to alter their portfolios simply to make them look better. They can make smart decisions and stick with them, regardless of how investment fashions change over time.

So, how have individual investors fared with these advantages? Unfortunately, not very well. A paper published in 2011 analyzed thousands of trades by individual investors and found that most investors trade too often, hold portfolios that are underdiversified, and most trades appear speculative or uninformed. The result is that the average individual investor has underperformed the stock market by roughly 1.5 percent annually. The most active traders

Reprinted with permission of the Rochester Business Journal.

underperformed by 6.5 percent annually.

So, while individual investors have largely squandered the advantages they have, there is much opportunity to improve. Individual investors have the ability to break out of the traps of the investment world to generate performance far in advance of what the pros have realized.

Mark Armbruster is president of Armbruster Capital Management Inc. He can be reached at (585)381-4180 or marmbruster@armbrustercapital.com

Reprinted with permission of the Rochester Business Journal.