August 31, 2001

Eagles Don't Flock

As one reads the literature, one gets the impression that most of our learned investing gurus don't manage to get above average results.

What's wrong with the above statement? Take a moment to think about it.

OK, the moment's up!

If there were no costs involved, one half of the investing professionals would place above and the other half below the average, after all, essentially they make up the average. Maybe the better way to put it is that one half of the monies put at risk in the market will earn above average returns while the other half will earn below average returns, maybe even bear losses. Although I haven't done the research, I'm fairly sure that the distribution of returns will probably create a bell or normal distribution curve.

But there are costs involved. Spreads, commissions, taxes and all sorts of fees reduce the performance of any investment portfolio as compared to broad market indexes which do not include these costs. The costs incurred in managing portfolios shift the bell or normal distribution curve to the left.

The next thing wrong with the initial statement is that it does not consider why the average stock market return is what it is and not higher or lower in any given year.

From the above I deduce that managing a portfolio involves two tasks: money management and asset management. Asset management, the buying and selling of securities and other investment vehicles, is the core task. To produce the best results, the asset management must be done at the lowest cost possible. This is what I call money management and it is the context task of investing. I am using core and context in the sense used by Geoffrey Moore in Living on the Fault Line. Core is what the business is about: steel for US Steel and oil for Exxon. Context

is what is required to make the business run but which, by itself, does not produce any benefits, for example, a shopping mall has to have public rest rooms, heating in winter and air conditioning in summer. None of them produce income but without them you lose your customers to other malls that have them.

Understanding why stock markets rise and fall is the first step in asset management, after all, you have to know the territory!

Many stock picking systems ignore all other asset classes. For example, The Gorilla Game analyzes how companies, or rather, their products, fit into product categories and value chains and then goes on to tell you how to pick the winners. The Gorilla Game posits that gorilla type companies will produce above average returns but does not talk about how the average itself is created. The Gilder Technology Report (GTR) does an excellent job of analyzing the underlying technologies of the Telecosm based on the economic duo of abundance and scarcity and then names some of the companies that posses the winning technologies. The GTR assumes that the companies relying on the best technology will be the winners in the long run and that has been proven to be a false premise. As a matter of fact, The Gorilla Game and more specifically, Inside the Tornado talk about how the market picks the winners. According to Moore, the tornado is a chaotic event and it is seldom possible to forecast which of the contenders will be picked. In Gorilla Gaming in Bear Markets I talk about the underlying scientific principles of marketing tornados derived from the Science of Complexity being studied at the Santa Fe Institute. As a last example, Louis Navellier tries to outperform the market with "What Works on Wall Street." Navellier uses Modern Portfolio Theory (MPT) based screens which he backtests on a quarterly basis. This method has served him and his subscribers well but since he is almost always fully invested, his portfolios ride up and down in close correlation to the overall market.

Moore, Gilder and Navellier are three of my favorite market gurus but none of them can tell you why and when the markets will rise or fall. Following Gilder in 1999 would have made you rich but continuing to rely on his advice through 2001 was a disaster. In reality, it was not Gilder but the bull market that ended in March 2000 that made you rich and it was the bursting bubble and the subsequent bear market that ruined you in 2000 - 2001. Gilder is an excellent source for understanding technology and you can use this knowledge to interpret

what Moore is saying in The Gorilla Game. Moore gives you some very general guidelines for when to buy and when to sell the stock of gorillas and gorilla wannabes but gorilla gaming is quite difficult. If you follow Louis Navellier's MPT Review to the letter, you will have some very good returns but it will not help you in understanding the markets.

In A Random Walk Down Wall Street, Burton Malkiel tries to fit the facts to his opinions about the market and about investing. His advice is to stick with index funds which have very low transaction and management costs. This is good advice because it leads to sound money management and it automates asset management. On the other hand, it eliminates the possibility of outperforming the market. Malkiel says that neither the technical analysts nor the fundamental analysts are in a position to predict prices because the market is too efficient. According to the Random Walk Theory, everything that can be known about a stock is already built into the price and the only thing that affects prices are fresh news which, by their very nature, are random. John Maynard Keynes played the market from his bed for half an hour each morning and managed to earn several million pounds for himself and to increase ten-fold the endowment fund of his alma matter, King's College. He did this using applied psychology. I quote:

> "(Most people are) largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but in forecasting changes in the conventional basis of valuation a short time ahead of the general public."

Louis Navellier is a more recent example of someone who knows how to take advantage of technical analysis. Warren Buffett and Peter Lynch can be classified as fundamental analysts and both have achieved very good returns in the market. The conclusion is that both technical and fundamental analysis work if used correctly. Malkiel bases his argument on the performance of the average market guru and, as was demonstrated at the beginning of this essay, the average guru must underperform the broad market indexes. In The Warren Buffett Way, Robert Hagstrom, discussing the efficient market theory (same as the random walk), states:

> "Yet the success of some individuals who continually beat the major indices -- most notably Warren Buffett -- suggest that the efficient

> market theory is flawed. Efficient market theoreticians counter that it is not the theory that is flawed. Rather, individuals like Buffett are a five-sigma event, a statistical phenomenon so rare that it practically never occurs."

Ross Perot has a sign in his office: "Eagles don't flock, you have to catch them one by one." BTW, in 1969, Buffett decided to close his investment partnership claiming that the market was highly speculative and that worthwhile values were hard to find. This was the era of the Nifty Fifty. I quote again from The Warren Buffett Way:

> "Buffett mailed a letter to his partners confessing that he was out of step with the current market environment. *'On one point, however I am clear,'* he said, *'I will not abandon a previous approach whose logic I understand, although I find it difficult to apply, even though it may mean foregoing large and apparently easy profits to embrace an approach which possibly could lead to substantial permanent loss of capital.'* "

In abandoning the market in 1969, Buffett, acted on the realization that the technical aspects of the market were overpowering the fundamentals of the companies being traded making it impossible for him to take advantage of these fundamentals. A very similar situation occurred during the last quarter of 1999 but most of us were not savvy enough to notice it or to act on it. Most of us are not five-sigma events.

The conclusion, so far, is that it is extremely difficult to beat the market but not impossible. Despite the fact that Malkiel's arguments about the efficient market theory are spurious, his advice to the average investor is sound, buy index funds.

In my next essay, I will discuss the rise and fall of markets as a first step in developing an investing strategy.

Denny
"Demand creates queues. Supply gets rid of them."
Software Times

I have not had the time to make Software Times interactive. In the interim, I would suggest we use the messaging board at the Telecosm News Club to exchange opinions about these essays.