Beating the market

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 “reversion 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!

First Rate Investing Minds -2.4%

US Stock Market +11.5%

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 16%. This 16% differential is the more appropriate comparison.

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