

The Problem with Experts

(The September, October, and November newsletters are adapted from a speech given by Bill Berg, Sigma's president, on September 23 at the fall retreat of The Financial Planning Association of Oregon and Southwest Washington. This month, we discuss the concept of expertise in investing, develop the "case" for tactical asset allocation and explain Wall Street.)

We are supposed to seek experts when we have a problem. Health issues? Find the best specialist available, at least the best one your insurance covers. Exotic estate planning difficulty? Find a law firm that focuses on such issues. But clearly, you cannot rely upon everyone posing as an "expert." Some may be charlatans; others may be sincere but ineffective. And how do you even measure expertise? To see the quandary, we need go no farther than the nightly weather report. Weather reporters should have their forecasts tracked against a passive benchmark of assuming each day's weather will be the same as the previous day. If they cannot beat that, why should we waste time listening to them? There is even less accountability for weather reporting than there is on Wall Street, and that is saying something.

Just as we have trouble making out what the weather reporter is waving at on the satellite map, we have trouble seeing the "meaning" in much of modern art. We are not alone - Alan Lee, a painter and visiting scholar in the philosophy department of Flinders University in Australia presented a dozen images to test subjects, including 100 art students and 10 recognized art professionals. Four were original paintings by Piet Mondrian, the 20th century Dutch "neo-plasticist;" eight were randomly generated combinations of black lines and colored enclosed spaces. Lee asked the subjects to pick the real Mondrians. The success rate of the subjects was somewhat less than what random chance would predict. Yet art critics can wax eloquent about the "meaning" behind Mondrian paintings based upon what they know of Mondrian's life and views on art.

The books describe tactical asset allocation as a counterpoint to strategic asset allocation. My textbooks inform me that the steps in strategic asset allocation include the following: (1) define the asset classes you want to use; (2) make your capital market forecast; (3) estimate the return and risk for each asset class and the cross-correlations between asset classes, (4) “optimize” these inputs to determine an initial portfolio; and (5) monitor and rebalance as needed. Gosh, that sounds like a lot of crystal-ball gazing to me. I have no idea what stocks are going to do tomorrow, next month or next year, and I cannot begin to think about how to estimate cross correlations between assets without just extrapolating the recent past. A review of history, however, tells us that

What about wine experts? The Times of London reports studies by Frederic Brochet suggesting the respect for their “expertise” may be overblown. Brochet had 54 French wine experts sample different wines, including a white wine that he had colored red. Not a single expert noticed the difference – if you are expecting to taste a red wine, you will.

Maybe everything we drink should be blue. Nobody knows how blue is supposed to taste.

In another test, Brochet had 57 experts taste the same bottle of Bordeaux on two different occasions – the first with a label on the bottle indicating it was a high-prestige *grand cru*, and the second with a label indicating it was cheap table wine. Over two-thirds of the experts thought

the wine good in the first test, while more than three-quarters thought it bad in the second. Brochet also indicates that the molecule providing the taste of currants or raspberries in red wine is identical to that which gives an apricot or peach taste to white wine. The description of taste varies solely because the color of the wine is different.

As you might imagine, there are those that contest the results of the Lee and Brochet experiments, and we certainly do not know enough about either modern art or wine to determine which side is correct. Our point is that you should not automatically accept any proclaimed expertise. Enjoy art and wine, just be a bit skeptical when someone informs you that an abstract painting clearly shows “the fascist boot of National Socialism” or, after a brief taste, opines that the grapes for a particular wine were grown on the north slope of the vineyard.

Let us look closer to home, in our own profession. Is there evidence of experts pretending to know more than they actually know? There are two kinds of people in this room: those that answer “yes” to that question, and liars. We know *poseurs* and big-talkers populate, if not dominate, our industry, so I do not need to dwell on this point. I will, however, suggest that we need to be wary of unwittingly falling into those categories ourselves. Do we really know what we think we know?

In market forecasts for clients, how many of you have discussed the economy? Did you accompany that with evidence demonstrating that a strong economy should lead to a rising stock market? Predicting the economy to predict the stock market has it backwards. Of the government’s leading economic indicators, the indicator that does the best job of predicting the economy is the stock market – the stock market predicts the economy, not the other way around.

How many of you have discussed strong earnings growth as a reason to be bullish on the stock market? Did you accompany that with evidence indicating that earnings growth leads to good market returns? Ned Davis Research, Inc. has analyzed the performance of the S&P 500 index

for various growth rates of the earnings of the component corporations going back to 1924. In general, the slower the earnings growth, the better the stock market did. Rapid growth in earnings correlates negatively with stock market returns. Only when earnings are too bad to ignore, falling at least 25 percent year over year (something that is true only 6 percent of the time since 1924), does that not hold true.

Most market experts in print or on television are bullish. Whatever the economic news, they believe it predicts a market rise. If the economy is bad, they say the Federal Reserve will cut interest rates and make the economy good. If the economy is good, well, the economy is good. It is almost always a sunny day in “talking head land.” They then say the strong economy will lead to earnings growth, therefore the stock market will go up. Unfortunately, as we have just seen, both these premises behind their predictions are incorrect.

When you look at the evidence, the world as described by most Wall Street strategists is upside down.

In other words, the world as described by most Wall Street strategists is upside down! A bad economy tends to be followed by good stock returns. Rapid earnings growth tends to be followed by poor stock returns. It therefore is unsurprising that following Wall Street strategists is a losing game. Ned Davis Research, Inc. has looked at market returns back to 1985 when Wall Street strategists, as a group, were extremely optimistic (a little over a quarter of the time) and the S&P 500 *lost* about 12 percent a year. When they were extremely pessimistic (also a little over a quarter of the time) the S&P 500 *gained* over 28 percent a year. If you take nothing else away from this talk, please remember that the next time you see a Wall Street strategist on television giving his or her opinion on the market, put your hands over your ears and start shouting “Wah, wah, wah” so you cannot hear them.

Every time I have written something about market timing that has been published, some cranky people write nasty letters to the editor, shocked that I could question that scads of people successfully time the market all the time. (If only we had evidence that they exist!) So let me make it clear - I am not saying it is metaphysically impossible for someone to time the market. We can say, however, that most people who hold themselves out as timing the market are failing in the endeavor. I also suggest that the theoretical successful market timer would be almost impossible to distinguish among the crowd of the charlatans or misguided individuals claiming that they are successful timers.

We can also conclude, if we think about it for a couple of minutes, that anything we read in a magazine or hear about on CNBC is unlikely to work, if only because that there will be too many people doing the same thing. Their actions will move the markets. Remember, the financial markets do not accurately reflect the underlying reality of business fundamentals. Rather, the markets accurately reflect only how the mass of investors feel about or perceive the underlying reality. Investor actions drive prices up and down, even if there has been no change in reality.

I assure you that if I had a foolproof market timing method, I would not be up here telling you about it.

The Case for Market Timing

I have spent a considerable amount of time now bashing market timing and the supposed expertise of people opining on market direction. Is there a case to be made for market timing? Most of you have probably heard the anti-timing logic that if you missed the 10 best days in the last decade, your returns would have been cut in half; what they tend not to tell you is that if you missed the 10 worst days, your return would have jumped by roughly the same amount, so that gets you nowhere.

The primary case for timing or tactical asset allocation is that, in the real world, the majority of investors cannot live without it. The best designed, most sophisticated, most elegant, most theoretically correct investment program will have little value if you do not also take into account investor psychology. For example, as the markets soared to new heights of both price and valuation in the late 1990s, some market bears drew parallels to the “Nifty Fifty” market of the early 1970s. Back then, investors paid previously unheard of valuations for a small number of top growth stocks, only to be savaged in the subsequent bear market of 1973 and 1974.

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for market timing
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The bullish rebuttal to these parallels was to point out that if investors had held onto those nifty fifty stocks until the mid-1990s, they would have broken even on a relative basis with the S&P 500. Now, I am not questioning the math ability of the people making this argument, just their grip on reality. We have a list of some of the Nifty Fifty stocks, including names like Disney, Wal-Mart, Marriott, McDonalds and Sony; the stocks fell an average of over 80 percent in the 1973-74 bear market. How many of your clients, how many of *you*, could lose four-fifths of your money and continue your buy and hold strategy, serene that you would break even two decades later?

A form of this same criticism can be applied to index investing, which relies on the ability of the investor to ride through markets both good and bad. Do you really think that some index investors, having lost 40 percent of their money in the 2000 - 2002 bear market, did not decide that it was time to sell and get more conservative? Going a few years further back in time, do you really think that many index investors, watching their neighbors and relatives earn huge returns in technology and other growth stocks in the late 1990s, did not decide it was time to sell the index and buy something more aggressive? The theory may work, the math may work, but the psychology has to work as well – people have to be able to live with their investment program for it to be effective.

The investor who bought the Dow Jones Industrials at its high in 1929 did not see that level surpassed until more than 25 years later in 1954. An investor in commercial paper in February 1966 did better than an investor who bought the Dow Jones Industrial Average and reinvested all dividends for 21 years until early 1987. An investor in 3-month T-bills has done better than an investor in the S&P 500 index since March 1998, more than seven years and counting – hopefully not counting for another 14 years, like in those other examples! There are times when it is difficult for people to see the benefit of “stocks for the long run.” That is why they will always be attracted to market timing, or at least service providers claiming they can time the market.

The Paradox of the “Financial Services” Industry

We work in the “financial services” industry, but I believe that is a misnomer. For most, it is actually a financial products industry. Most in our industry develop products – insurance policies, annuities, mutual funds or hedge funds – and then figure out how to sell those products to the public. More precisely, they figure out what they can sell to the public and then “manufacture” the corresponding product. I was going to say they manufacture the appropriate product, but financial products created in this system are almost invariably inappropriate for most investors.

Why do you believe there were so many new technology mutual funds in the late 1990s? There was not a sudden explosion in the supply of qualified, experienced, excellent technology stock managers. Wall Street “manufactured” these fund products because they knew that anything with “technology” in the name could be sold to a public clamoring for the opportunity to get in the game.

This is the only service industry dominated by product manufacturers.

Thinking about Wall Street in this way helps explain the paradox of people predicting the future of the stock market, based upon the economy or earnings growth, when the connection of their data to their prediction is the reverse of what they think. It matters little if what they say is ultimately correct, as long as it helps to sell their products. Success for them is closing the sale, not having their predictions be correct. The predictions sound plausible to their audience, however wrong they may be. This also explains the normal prevalence of bullish opinion by strategists – most customers want the market to go up because they need to make money investing. Which fortune teller are you likely to go back to – the one predicting a bad moon rising, or the one who tells you that you are on the brink of true love and fortune?

Finally, we should also realize that investors have a strong need to believe that someone, somewhere knows what is going on. The alternative is to believe there is only chaos in the markets, and nobody wants to submit their future retirement to a system full of chaos. For all these reasons, even ineffective investment predictions “work” – Wall Street’s customers reward the people making the bad predictions, by buying their products, even if it is just an exercise in wish fulfillment. As long as bullish predictions based upon a supposedly strong economy and rapid corporate earnings growth sell product to investors, it would be idealistic to expect the misinformation to stop.

Saying that the economy is growing, earnings are good, and therefore the stock market will rise is what people want to believe, so “experts” making predictions based on that logic prosper. It is flattering to have an expert agree with you. I can tell you from personal experience that saying the economy is growing, earnings are good and therefore stock market returns will be poor is a crummy marketing strategy, as is telling people that the economy is in a recession and earnings are poor so now is the time to buy. It just seems counterintuitive to most people – and we all want life to be easy.

People seem to need to believe in market timing and expertise, no matter how ineffective it is.

So, we have a potent and somewhat dysfunctional combination of factors in the investment world. On the one hand, we have an investing public that needs (at least in a psychological sense) market timing and “expertise.” On the other hand, we have an industry that preys upon these needs to sell more of its products. There is also an asymmetry within the industry, given

that a bullish stance aids selling investment product. People in our industry who are bullish when the market goes down are just members of the club. In contrast, people who are bearish when the market goes up invariably are fired.

If we are to be true professionals, we need to be cognizant of these quirks and seek to be advisers rather than enablers. In investing, as in medicine and law, the customer is not always right. If you are a professional, you are not just selling product. You are willing to seek out the truth, or at least evidence of the truth, and to question the assumptions behind what everyone else does. You are willing to turn away business if you believe the client wants to move in a direction that will be harmful. You are advising your clients, not just doing what “works” to earn a commission or fee.

Sigma provides investment management and consulting services for individuals, corporations, trusts, endowments and retirement plans. If you would like our help, call us at (503) 419-3938 or e-mail us at info@sigmainvestment.com.