

Hamilton Burger's Revenge

Defense attorney Perry Mason battled district attorney Hamilton Burger in weekly murder trials for nine television seasons (1957-1966) and daily ever since in syndication. Those who criticize the competence and ethics of the Los Angeles police department based upon relatively recent incidents should realize that this is nothing new. After all, *each week*, Perry successfully fought for the life of an incorrectly accused defendant. Burger's career has its own puzzles. You have to admire his zest and passion, given his unbroken string of losses. Burger, however, had some sloppy habits as a courtroom lawyer. During the trials, he would repeatedly bark out his standard, all-purpose objection "irrelevant and immaterial," and it usually did not work. Mason's favorite objection was the targeted "assumes facts not in evidence." This was much more successful since Burger was continually assuming facts not in evidence.

However fruitless his career, though, district attorney Burger would be right at home among today's investors. The basic investing paradigm followed by investors for the market as a whole and reported daily by the media is a model of assuming facts not in evidence. Think about the central story you hear on a typical market report. A strategist will opine that the economy is strong, that earnings will grow, and that these factors will lead to good stock market returns. Looked at logically, believing this story means that you believe in the truth of the following propositions: (1) GDP growth leads to above average stock market returns; (2) earnings growth leads to above-average stock market returns; and (3) it is worthwhile listening to the Wall Street strategists putting forth these facts. This story sounds plausible enough on the surface, but unfortunately, the evidence suggests that each of these propositions assumes facts not in evidence.

First, the stock market predicts the economy, not the other way around – in fact, the stock market is one of the best of the government’s leading economic indicators. Looking at the data since 1960, very strong economic growth accompanies *negative* stock market returns, while very weak economic growth accompanies above average stock gains. Plausible as the “strong economy therefore strong stocks” proposition sounds the evidence suggests the reverse.

Second, earnings growth usually does not lead to good stock market returns, at least in aggregate. True, when S&P 500 earnings are falling very rapidly, the stock market has horrible returns, but that only happens about 6 percent of the time. The other 94 percent of the time, earnings growth correlates negatively with stock market returns. The faster earnings grow, the lower the returns from stocks. This is seriously counter-intuitive; if you own a business and its earnings grow, your business should be worth more. The stock market, however, usually discounts information very efficiently. Market prices already reflect anticipated earnings growth for the market as a whole. Again, the proposition is plausible, but not supported by reality.

However plausible or alluring the story, reality and the truth are what matter most.

Third, why not follow the advice of Wall Street strategists? They hold lofty positions at major investment houses; their training and experience should give them an edge in investing. Once again, though, the evidence rears its ugly head. Since 1985, when Wall Street strategists have been very optimistic, the S&P 500 has lost money; when they

are very pessimistic, the market has gone up more than 28 percent a year. The strategists seem to be relying upon the “economy good → earnings good → stock market returns good” paradigm, and since each of the component propositions of the story is false, it should be no surprise that the strategists (and investors following the paradigm) have a woeful record.

What is a surprise, however, is that nobody seems to ask for evidence of the efficacy of the investment paradigm or the truth of the three propositions. When you talking heads talking about stocks going up due to robust earnings growth, do they ever present evidence to warrant why you should believe that one leads to the other? Has an economist on TV ever given evidence that a growing economy leads to buoyant stock market returns? Do the Wall Street firms hiring the strategists ever compare the batting average of their predictions relative to a fair benchmark?

While Perry Mason’s show inspired legions of children to become successful professionals, none of them dreamed of growing up to become Hamilton Burger. In the end, reality is what matters, not an easily told but false story. If searching for the truth, following where the evidence leads and acquiring a logical investment program are important to you, give us a call at (503) 419-3938 or contact us through our website at www.sigmainvestment.com. Taking any other course of action would be irrelevant and immaterial.

Data from Ned Davis Research, Inc.