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Investment Advice Can Be Better to Give Than Receive

Overview: When the markets tumbled, many investors began looking for advice on how to save their portfolios. However, listening to that advice may have made many of them worse off.

Investors are no doubt happy to see the recent run-up in the stock market, given months of watching portfolio values drop. However, these gains also serve as a reminder of why sticking to an investment plan is important to capture those gains.

Is It Really a Stock Picker's Market?
In many cases, investors feel a desire to start searching for the next hot stock or asset class when times get tough in the stock market. The natural tendencies to want to do something certainly are not assuaged by the media.

Consider the words of Joe Weisenthal of *The Business Insider*: "Hardly an hour goes by without hearing some guy on TV — often a mutual fund manager — extolling the benefits of a diverse stock portfolio, proudly claiming that it's a 'stock picker's market.' Of course, the guy will never say otherwise. He'll never say it's a good time to be blindfolded, throwing darts."[1]

Historical evidence suggests that an investor's best course of action is to stick to his or her investment plan. Consider the following from *Bloomberg*, which compiled rankings of analysts' recommendations since the March 9 lows: "Anyone who did what Wall Street analysts advised last March has only losses after the biggest stock market rally in seven decades."[2]

According to *Bloomberg*, "an investor who used $10,000 to buy companies in the highest-rated industries and bet on declines in the lowest since the advance began on March 9 lost everything and would owe as much as $6,000 to cover bearish trades."[3]

The recovery during the past five months has been lead by companies with the worst earnings. However, many securities firms touted drug and energy producers. While these companies have not fared poorly, they have trailed the MSCI World Index by more than 24 percent. The problem lies in trying to identify winners ahead of time.

Consider these examples of how analysts' recommendations have missed the mark:

- "Buys" made up the majority of recommendations on European utility and health-care companies in the S&P 500. In the past five months, neither group has advanced more than 28 percent, while the MSCI World has risen 52 percent over the same period.

▲ Financial institutions and retailers had the highest percentage of "hold" ratings, yet the groups beat the return of the S&P 500 Index with advances of at least 58 percent since March 9.
▲ Regarding financial institutions, analysts assigned "sells" as 28 percent of their ratings on European companies and 14 percent of their ratings on U.S. companies. "Both the S&P 500 and MSCI Europe groups have more than doubled since the rally began."[4]

Seeing Connections Where They Don't Exist
In an effort to identify these winners, some analysts turn to data mining in hopes of discovering a pattern that will tell them the next winning stocks, sectors or asset classes. But as *The Wall Street Journal's* Jason Zweig pointed out in his August 8 column, "Slicing and dicing data to predict the future can get dicey."[5]

One of the most popular examples of how data mining can be misused comes from David Leinweber, a veteran quantitative money manager. Leinweber's goal was to find the most absurd statistic he could to poke fun at data mining practices. He found a statistic that "explained" 75 percent of the variation in the S&P 500's annual returns over a 13-year period. That statistic turned out to be butter production in Bangladesh.

Before dismissing this as a farce, it should be noted that Leinweber improved the accuracy of being able to predict returns: "By tossing in U.S. cheese production and the total population of sheep in both Bangladesh and the U.S., Mr. Leinweber was able to 'predict' past U.S. stock returns with 99 percent accuracy."[6]

Leinweber's research was done to point out the potential fallacies of data mining, in particular how statistics can be manipulated to show relationships where none exist. Still, many researchers continue their quests to find ways of predicting market directions, no matter how outrageous. One working paper certainly held an enticing headline: "Exact Prediction of S&P 500 Returns." The method for predicting the returns, however, may not be as thrilling: "Our aim is to describe S&P 500 returns using monthly readings of (the) 9-year-old population in the USA."[7]

Summary
As Gregg Easterbrook once said, "Torture numbers and they'll confess to anything."[8] Perhaps the most important words to consider about investment strategies come from Leinweber, who said "If a strategy's worthwhile, then it'll still be worthwhile in six months or a year."[9]

1 Joe Weisenthal, **No, It's Not a Stock Picker's Market.** *The Business Insider*, May 5, 2009.
2 Lynn Thomasson and Adria Cimino, **Taking Wall Street Advice in Rally Means Owing $6,000.** *Bloomberg*, August 18, 2009.
3 Ibid.
4 Ibid.
5 Jason Zweig, **Data Mining Isn't a Good Bet for Stock-Market Predictions.** *The Wall Street Journal*, August 8, 2009.
6 Ibid.
7 Ivan Kitov and Oleg Kitov, **Exact Prediction of S&P 500 Returns.** Working Paper, December 2007.
8 David Gonos, **Numbers Are a Fantasy Owners Friend and Enemy.** *CBSSports.com*, May 27, 2008.
9 Zweig.

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