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2010: Second Quarter

The Secret of (Not) Investing

By Eric G. Hoffman, Chief Investment Officer

One of the most commonly quoted financial theories put forth in the past 25 years states that more than 90% of the returns of a portfolio are due to the manager's Asset Allocation Policies, with the remainder due to Active Management. This theory stems from seminal research on the subject dating back to the mid-80s.

Unfortunately, new research indicates that this figure is no longer accurate.

To begin with, the authors of the study never said that "returns" were based on these factors; their discussion was solely related to the "variation" in returns. So, while the differential in returns between two large cap growth portfolios may be attributed to asset allocation and, to a lesser extent, active management, it only applies when comparing apples to apples. Trying to assess the variation of returns between a large cap growth portfolio and a short-term fixed income portfolio under the same framework wouldn't be a valid comparison. The allocation of the portfolio assets isn't even remotely similar, so why would they be expected to have similar returns?

New research, however, indicates that the whole concept needs to be revised. According to the new study, about three-quarters of a typical portfolio's variations in returns result from - get this - market movement! Presumably, this means that the variation is directly related to the decision regarding whether or not to be invested in the market. If the market goes up and you're not invested, you underperform. If the market goes down and you're not invested, you outperform. The remaining variation is purported to be approximately evenly split between asset allocation policy and active management, i.e. specific trades and the timing of those trades. Remember, that this is simply a discussion of the variation of returns – active management could just as easily contribute to a negative variation as it could to a positive.

I do, however, take issue with this study to some extent. I obviously don't contest the figures that they use on which to base their conclusions, but I do question their definitions. One of the first books that I read about trading, an anthology of interviews with famous traders, had a quote in it that has always stuck with me, "Sometimes the best trade is no trade." If this is true - if the decision to be in or out of the market is an active one – then shouldn't the "market movement" classification of the study be included under "active management"?

The decision to be invested or not is not a "black or white" one, though - there are infinite shades of gray. A portfolio manager isn't locked in to only being fully invested. He or she could strategically allocate portions of the portfolio, based on perceived risks and rewards of the market. In fact, as I've previously discussed, I favor reducing equity exposure as markets are heading up ("selling high") and increasing it again when markets sell off ("buying low"). Utilizing this type of strategy, I believe that it would be hard to argue against including "market movement" along with "active management."

Of course, it could also be argued

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that "market movement" should be included along with "asset allocation." After all, isn't the cash/equity decision a choice of which is a more appropriate asset class at a particular point in time? And, isn't cash just another asset class, just like large cap, small cap or fixed income? Is there really much difference in considering the decision to include cash as a "tactical" part of an asset allocation than classifying it as an "active" portfolio component?

Which brings me back to my point for this entire discussion: Don't be afraid to hold cash. It's an important part of your portfolio. You don't always have to be fully invested; leaving a portion of your portfolio liquid may give you tinder should better opportunities arise. By strategically "taking profits" when the opportunity arises and adding to positions when your favorite names go down (buying them at "sale" prices), you may have the opportunity to buy low, sell high and have the potential to maximize profits.

The Inefficiency of Markets and How to Play It

By Anish Ramachandran, Investment Analyst

Once the gold standard of all Financial Theory, the Efficient Market Hypothesis (EMH), it was probably one of the most highly debated topics. In its simplest form, the EMH asserts that markets are "informationally" efficient - that all available information about a stock is reflected in its price and that any adjustment to new information is virtually instantaneous. According to the EMH, by using available information, all market participants arrive at "rational expectations" forecasts of future security returns and that these forecasts are reflected in the prices that are observed in the markets.

The concept of rational expectations is one that works in theory, but not as well in practice. The EMH assumes that all market participants have the same expectations about future security returns. Clearly that assumption is not realistic because if you and I had the same expectations, then why would we trade? After all, the action of trading implies the existence of different expectations.

Despite some of the EMH's strengths, there are some aspects of it that we disagree with. A big implication of the EMH is that the current price of a stock is "correct" and that the mis-pricings of equities are so small and so infrequent that they are not even worth looking into. If that were the case, then Warren Buffet, in his own words, would be "a bum in the street with a tin cup", and those of us here at Ken Stern & Associates would definitely not be in the business of asset management. The rest of this article will shed light on some of the investor psychology and market anomalies that appear frequently and present us with potential opportunities to take advantage of mispriced securities.

The EMH became controversial after the detection of certain anomalies in the capital markets. More recently, it has come under attack from the field of Behavioral Finance, which takes into account the human tendency to behave irrationally when making investment decisions. Let's take a look at some of these anomalies and behavior patterns that may lead to market inefficiencies:

Over/Under Reaction of Stock Prices to Earnings Announcements – Studies have shown evidence of both over and under reaction to earnings announcements. This is especially true for stocks that have previously generated inferior earnings performance. Once these stocks report a positive surprise, they tend to generate "excess" returns over a period of six months. The main reason for the under reaction is that, before the surprise, most of the investment community is bearish on the stock. When the stock generates favorable earnings, the results are often met with skepticism and it takes the investment community some time to act on the new information. Clearly, the new information is reflected in the stock price over months, not immediately as the EMH states.

Bubbles – Bubbles are an obvious anomaly, where the market often appears to be driven by buyers operating on irrational exuberance. The prices of both tech companies in the late 90s and housing in this decade were well above their justified values, based on fundamentals. If the markets were perfectly efficient and all investors were rational, then there would be no bubbles.

Loss Aversion – Loss aversion refers to the fact that, for most people, the fear of losing money is greater than the elation of possibly making money. You might say, "Shouldn't investors try to avoid losses?" While it is rational to avoid losses, it's also true that an excessive fear of loss can negatively affect the investor's prospects. For example, during bear markets, many investors become extremely risk-averse and decide to move some or even all their money out of stocks. Oftentimes, they decide to get back into stocks when the stocks are well off their lows. This strategy of selling low and buying high is not rational, but it is seen quite often when investors panic. The flip side of this equation is that bargain hunters will buy at reduced prices, when the other investors are selling. For them, the best time to buy is when there is fear in the market because that is when prices significantly deviate from their "value."

Reference Dependence – Investor and Analyst forecasts and decisions seem to be dependent on their reference point. These forecasts are often overly optimistic in a rising market and likewise overly pessimistic in a falling market. For example, in 2008, everyone talked about the collapse of the housing market and the U.S. going into a recession. But if you were looking at the analyst estimates for 2008, the recession would be the last thing on your mind, as analysts expected earnings for the Standard & Poor's 500 Index to increase by 15-18% for the year. Increasing 2007's S&P 500 earnings figure of $86.20 by the predicted increase lead to projected 2008 earnings of $100. Investors using analyst estimates as an indicator of market direction kept buying. We all know that 2008 saw unusual market turmoil and actual S&P 500 earnings came in at $68. Conversely, when the market was in free fall in early 2009, the 2009 estimates were close to $50 per share but the actual number for 2009 came in at $65. This excessive optimism or pessimism leads to mispriced securities, which rational investors can take advantage of.

Reflecting on the above is a small subset of the anomalies and behavior patterns that exist in the market and contradict the EMH. These anomalies give rise to mispricing of assets relative to their fair value. One of the implications of the EMH, as mentioned before, is that it is fruitless to look for mispricings as they disappear almost instantaneously. For a moment, let's assume that to be true. Then the question that needs to be answered is why are so many firms spending their resources gathering information that they can use to obtain an edge? This implies that either spending time and effort gathering information is profitable or all of these firms are irrational, because no rational person would waste time in activities that generate zero profit. Basically, in all practicality, the EMH is contradicted.

So, the next time you see a $20 bill on the street and your friend tells you that it doesn't exist because, on an "informationally" efficient street, it would have been picked up already, you can tell your friend that he isn't looking hard enough!

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