Stock Market Alchemy - or achieving superior returns on a consistent basis

by IMCZ Member John Henry Smith

The ancient practice of alchemy was the transmuting of base metal into gold. Financially, it could also mean the conversion of stock investments into abnormal profits. We know, of course, that the wizards of old never did succeed in their quest, and equally the vast majority of investors have learnt that they are unable to make abnormal profits in the stock market. This attitude stems from two studies, the first known as the Efficient Market Hypothesis (1965)[1] and the second the Random Walk Hypothesis (1973)[2]. Together they proclaimed that because all available information is immediately impounded into stock prices any attempt to eke out more than an average return is futile, particularly for Tom, Dick and Harry who stand on the periphery of market action and not at its epicenter. The acceptance of this lore explains the rise in popularity of the index funds and is reinforced by financial advisors, who point out the increased risks of seeking returns higher than the market average.

In stark contrast to these theories, the equities markets have produced their own wizards, who found unimaginable Eldorados through their own brand of financial alchemy. The most famous of all is Warren Buffet, the Sage of Omaha, who amassed a staggering personal fortune of $36 billion. A $10,000 investment in Berkshire Hathaway in 1965 would be worth $50 million today. His magic recipe is to buy stocks trading near their tangible asset values, as evidenced by his recent $5 billion stake in Goldman Sachs.

Another wizard is Peter Lynch, who started managing the Fidelity Magellan Fund in 1978 with assets of $20 million. When he retired in 1990, the fund had assets of $14 billion and is today worth $50 billion. Lynch's formula was continually adjusted to meet new market challenges, but the key ingredient was that you had to know what you were investing in with the result that his fund had an impressive average annual return of 29%.

My last financial alchemist is Michael Steinhardt of Steinhardt Partners, who achieved a performance track record that still stands out on Wall Street of 24% compound average annual returns that more than doubled the S&P 500 over a 28 year period. Amazingly, his trading strategies ranged from 30 minutes to 30 days.

Of course there are countless other financial wizards; too many to recount here, who make up a large body of market practitioners of different styles and strategies that clearly disprove these hypotheses, otherwise they would never have made the fortunes they did. I therefore believe that the broad perceptions of investors, instilled by fee- and not performance-driven advisors, that the making of excessive returns is booby-trapped with too much risk is simply a case of a self-fulfilling prophecy! Giving due weight to risk/return ratios, main stream equity investors ostensibly pursue recommended safety first and return second strategies only to see their chosen funds fall in this recessionary environment almost in unison with others that had produced higher returns and therefore bore an ostensibly higher risk label.

What is truly horrifying are the billions of dollars written off so far by the banks that invested in the U.S. securitized sub-prime mortgage market; the very institutions that lecture their customers on the merits of risk reduction, and, if nothing else, are thought to have understood risk management, but clearly didn't! Surely it raises the question of whether the modern-day investment wizards and their genre are right about risk and return or the propagators of sub-prime portfolio performance on account of their fractured, if not complacent, views of risk quantification.

On May 25, 2006, I asked my wife, Benita, who knows absolutely nothing about the equities market to randomly select a number of U.S. stocks from a newspaper, whereby she chose 44. The idea was to test whether a naively selected portfolio could beat the market or whether substantial skills would be needed, making stock selection the reserve of professional analysts and portfolio managers. As of September 24, 2008, the SP500 lost 19.2% of its value over the period and my wife's portfolio is up 3.6%! These results seriously call into question of what sort of skills that are really needed to modestly beat the market. One Prof. Bruno Solnik[3] in 1974 showed that through naive diversification, 65.5% of all specific stock risks are diversified away. The remaining 34.5% cannot be, because it is the market risk inherent in a particular stock market. This suggests that Benita's portfolio took on the risk/return characteristics of the market, even though through naive selection it performed marginally better. And when we look at the average performance of vanilla equity funds, we see very similar results; the only difference being is that Benita has no investment skills whatsoever. In support of this argument I quote Benjamin Graham, "the Father of Value Investing", who said, "To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks."

A lesson of the Efficient Market Hypothesis is that to make extraordinary gains, your opinion must be different from the majority. The following list of 20 stocks illustrates how extraordinary gains are able to be made by identifying stocks starting an upward surge and becoming fuelled by their own trends, because the catalysts are the stocks' very strong fundamentals. Of course, every savvy investor knows that trends don't last forever. That's why the quest is the continued search for stocks that fit the current economic climate. It is therefore very clear that proper stock-picking can not only immunize a portfolio against bear market pressures, but can deliver handsome returns:

Sector	Date in	From In-Date
Consumer Services	22-Apr-05	318%
Beverages - Soft Drinks	13-May-05	272%
Auto Parts Wholesale	1-Apr-08	252%
Industrial Electrical Equip	22-Apr-05	248%
Personal computers	11-Jul-05	238%
Internet Software & Services	31-Jul-06	172%
Restaurants	31-Jul-06	158%
Education & Training	31-Jul-06	150%
Oil & Gas Drilling & Exploration	6-Jun-05	134%
Business/Management Services	24-Oct-05	131%
Auto Parts Wholesale	10-Aug-05	127%
Home Health Care	22-Apr-08	126%
Oil & Gas Equip & Services	6-Jun-05	118%
Farm & Construct Machinery	31-Jul-06	118%
Oil & Gas Equip & Services	6-Jun-05	112%
Apparel Stores	29-Dec-05	109%
Oil & Gas Equip & Services	29-Dec-05	108%
Medical Appliances & Equip	27-Jun-05	106%
Telecomm Services - Foreign	31-Jul-06	104%
Industrial Metals & Minerals	27-Jun-05	100%

Did the magic of our great financial wizards enable them to find latent asset value before the market as a whole did; a value that produced sustainable trends like these above until the tide of some powerful competitive force caused a decisive trend reversal? Or was the real alchemy the courage to break the bounds of conventional wisdom, thus creating for themselves a new paradigm that better understood market dynamics and took away the fears of uncertainty that plague we lesser mortals? Whatever it was they beat the alchemists of old and gave us their wisdom to think about so that we too can make excessive returns on a consistent basis.

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[1] *The EMH was developed by Professor Eugene Fama of the University of Chicago Graduate School of Business, although it was first expressed by Louis Bachelier, a French mathematician, in his 1900 dissertation.*

[2] *A 1973 book written by Burton Malkiel, Professor of Economics and Finance at Princeton University, U.S.A. entitled "A Random Walk down Wall Street".*

[3] *Bruno Solnik is Distinguished Emeritus professor of Finance at the HEC-School of Management in France.*