

Reexamining Accepted Market Wisdom

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The investing industry has often had a love/hate relationship with academic research. In the second half of the twentieth century when market efficiency studies argued in favor of indexing, there was a lot of pushback. This often came in the form of ridicule and arguments on the difference between theory and practice. At the same time, many ideas from academic literature have been eagerly adopted and turned into new types of investment products. A recent example of this is factor investing and smart beta, which has driven an explosion in new ETFs.

This is not new however. Through the decades, mutual funds have often reflected the academic literature of the times. Whether it was funds devoted to small caps, value, or even low priced stocks, the influence was there. The success of firms like Dimensional Fund Advisors paved the way for the portfolio tilting approaches that have become so popular today.

I have often enjoyed reading academic studies as a source of new ideas or markets to examine. Local university libraries have always represented a quiet place to go and get free access to financial information and publications. Innovative concepts are always welcome, and often change our thinking on the best approaches to investing. In this article, we will look at a couple of recent academic papers that challenge established views on investing. Both of these papers are available at [SSRN](#), which can be used to access research in a variety of disciplines.

Are Some Widely used Approaches Based on Weak Data?

In the academic paper [Replicating Anomalies](#) (2017,) authors Kewei Hou, Chen Xue, and Lu Zhang undergo an exhaustive study of 447 market anomaly variables. The majority fail to hold up under analysis. The paper is interesting reading in that it addresses many of the most publicized market anomalies of the past fifty years. These include value and growth strategies, earnings surprises, small caps, quality of earnings, and momentum.

The main issue the authors find that prevents factors from holding up is the prevalence of microcap stocks in the data. According to the authors, microcaps represent slightly over 3% measured by capitalization of the domestic investable market, but are responsible for more than 60% of the stock listings. This creates concerns with liquidity and cost issues that negate the excess returns noted in many studies.

Indeed, this has long been a criticism of many studies that purport to find superior returns in smaller stocks. It only increases the further back in time you go, when larger bid/ask spreads and less detailed pricing information muddy the picture considerably.

While the authors can replicate momentum strategies, the effects of trading costs and taxes can greatly reduce stated returns. This only makes sense given that the more you trade, the greater the drag is from making those trades. Still, people often forget this when looking at raw returns.

The anomalies that do the worst when reexamined are those in the category the authors label trading frictions. These include short term reversals of price as well as multiple studies involving share volume and volatility.

The effect of many well-known earnings anomalies including earnings momentum, revision in analysts' forecasts, and excess returns around earnings announcements is much more muted the original studies suggest. Dispersion in analyst forecasts, which received a lot of press early in this century, fails to replicate.

In summarizing, the authors cite the work of John Ioannidis who wrote the paper [Why Most Published Research Findings Are False](#) (2005). They note characteristics in which study results are more likely to be false. These include small sample sizes, smaller effects being measured, conflicts of interest, and results generated statistically from data sets rather than from testing economic theory.

[Replicating Anomalies](#) finds many of these characteristics in stock market research, creating an environment for data mining. The study authors highlight the large rewards involved in creating financial products based on market anomalies, something that has only increased in recent years. Additionally, academic career advancement is often tied to the results cited in papers.

Motivating factors are not limited to investing. In horse racing, past performance providers have often felt the need to supply new and interesting data to their customers. One kind of data that is supplied is detailed trainer statistics. I have noted in the past that if you track each angle, the outperformance does not persist over time for most

factors. In fact, since these statistics are available for download, it is easy to test for persistence. Still, the statistics are often presented on telecasts and used by handicappers to justify selections. So regardless of performance, there is a demand.

The authors note that most studies do not use data outside of the United States markets. Indeed, this practice is rampant in the financial services industry. The stellar record of domestic equities over 20 year periods is often cited as if it were a law of nature. These results lead investors to greatly underestimate the risks inherent in equity markets. Failure to reproduce anomalies in foreign markets can act as a crucial red flag in judging the validity of strategies.

So, what is the upshot of Kewei Hou, Chen Xue, and Lu Zhang's findings? Prospective investors should probably always look at market anomalies and research with a critical eye. Given the subsequent results of market research, they should be looking to poke holes in theories rather than accepting studies at face value. A recent Financial Times article noted a huge increase in the amount of money (\$24 billion) devoted to smart beta strategies in the first quarter of this year compared to 2016. Given this and the explosion of Exchange Traded Products in general, it makes sense to cast a wary eye to claims of market beating strategies.

Do Stocks Outperform Treasury Bills?

Hendrik Bessembinder uses this provocative question as a hook in [the title of his recent study](#) using the Center for Research in Security Prices database (CRSP) from 1926 until 2015. He finds that more than half of all listed stocks have a negative return over their lifetimes and slightly over forty percent outperform one month treasury bills. He also finds a very small group of stocks account (30) for nearly a third of the total wealth creation from equities since 1926. Bessembinder notes the poor winning percentage as an explanation for the weak performance of active managers.

The conclusion that many have come to as the result of this study is that it defines the perilous nature of owning individual stocks. They argue that since a few large gainers account for most of the market advance, they will be impossible to find. Thus, the only hope would be an index which gives you enough diversification to capture the market return. But is this really the conclusion you should draw?

One issue is microcaps. As *Replicating Anomalies* points out, they exert an outside influence when you consider stock returns in terms of listed companies. So, does it come as a huge surprise that Professor Bessembinder's research shows less than half of the smallest decile of stocks show a positive return over periods of a decade? His research demonstrates that the highest market capitalization companies have an 80% positive return rate over the same time frames.

As for the active manager question, I would argue that cost remains the overriding factor in underperformance. There is a difference between difficult and impossible. Yes, it will always be a small group but my guess is given a reasonable size portfolio and low costs, Will Danoff, Jim Simons, Warren Buffett, Seth Klarman, Charlie Munger and a host of other talented people will always outperform. Taxes should also be considered in an individual's personal calculus.

As for diversification, raw numbers only tell part of the story. The types of companies you are investing in have a huge impact. To return to a horse racing analogy, a bettor wagering on even money favorites will need less bets to diversify than a longshot specialist. Still, understanding the odds you face and the lay of the land is important. The paper raises important questions about diversification.

The appendix table with the 30 wealth creation standouts reads like a Who's Who of domestic industry over the last 75 years. The names include Disney, McDonalds, General Electric, Walmart, and Home Depot. Tech is represented by Apple, Microsoft, IBM, Alphabet, Oracle, Intel, and Amazon. The question is whether these were identifiable in advance.

I believe everyone should have a low-cost index fund account (even if just to compare to). But, I also believe the game is worth playing. The life changing returns on companies like Microsoft, Oracle, Alphabet, and Dell were within the reach of investors. When the former began a nearly 150 times increase (total return) from early 1989 until March 2000, the company was already well established as the major player in desktop software. Alphabet was very profitable and was described by Barron's as producing "the most eagerly anticipated registration statement, since, well, let's call it forever" three months ahead of their IPO in 2004. Let history be a guide, whether it warns or enlightens.

The paper should have you looking at your portfolio, examining your success rate, and determining where the bulk of your gains have come from and how they square with the indexes.

Changing your Perspective

One nice thing about reading publications online is that it's easier to access archives now. This is more efficient than searching through rows of bound periodicals to find the information you are looking for. In the financial realm, tools like Times Machine from the New York Times or the 20 years of archives Barron's offers to subscribers are useful. Since many different market cycles are covered, you can see what the thinking was at the time. What was once common wisdom always gives way to new and better information.

As the Replicating Anomalies paper shows, even research based on what seems to be solid data may later be disproved. At different periods of time, certain ideas take center stage only to have their utility found wanting when all is said and done. Reading history as it happened can help give a clearer view of how current events can be interpreted.

Recently, Amazon celebrated its 20th anniversary as a listed company. In the wake of the incredible return the stock has generated, it was fun to go back and look at the famous [Amazon Dot Bomb](#) Barron's story from May 1999. It was interesting to track the challenges and competitors the company faced.

One guesses these types of archives will become available for many more publications. You may not have lived through every bear market, but you can certainly gain from understanding how they played out.

Conclusion

In this article, we reviewed two recent academic papers that advised taking a critical view of common investing perceptions. The first highlighted an inability to replicate much of academic research on equities. As a result, investors should be careful to accept seeming market inefficiencies at face value. The second focused on the fact that market gains over the last century have been driven by a small number of huge winners. The risks involved in stock selection are often overlooked in the narrative of equity returns as a superior asset class.

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