November 10, 2004

Evaluating the Alternatives

Introduction

It has become depressingly easy to find detailed, plausibly reasoned notes from investment analysts arguing that the US equity market will deliver poor, or even negative, returns for the foreseeable future. Increasingly, these analyses are finding their way into the financial press. This week's *Barron's*, for example, cites a prediction by Martin Barnes of the *Bank Credit Analyst* to the effect that "a typical balanced pension-fund portfolio isn't likely to return any more than 5% a year over the next decade."[1] Some forecasts are much lower. Such predictions can tempt disciplined investors to restructure their portfolios. How do we evaluate them, and the merits of some of the proposed alternative investment approaches that often go with them?

Those predicting low market returns are not likely to possess knowledge of future events that is not otherwise publicly available. So it's important to consider their point of view. Many of the writers making these predictions have investment products to sell, and their commercial interest or their investment worldview may bias their outlook. Biased or not, these writers do not typically explain why their predictions present a credible alternative to the Efficient Markets Hypothesis. As always, investors must evaluate these predictions and products critically to determine whether they have a place in a disciplined investment program. It isn't any near-term market prediction that guides the construction of disciplined portfolios. It is the suitability of all the investments, taken individually and as a whole portfolio, that matters.

Consider the Source

Some traditional stock-pickers argue that returns in the broad market will be poor, but if you know how to pick the right stocks, you should do well. Market timers may say that maintaining long-term market exposure is a likely path to disappointment, but that judicious moves into and out of stocks and other assets can fill the gap. And hedge fund managers sometimes posit that their skill is great enough to tease handsome profits out of the meager raw material of weak market returns.

[1] Randall W. Forsyth, "Up and Down Wall Street," *Barron's*, November 8, 2004, 6-8.

750 Menlo Avenue Suite 300 Menlo Park, CA 94025 (650) 566-0200 Office (650) 566-0210 Facsimile

Promoting an investment strategy as an antidote to anticipated market weakness is unconvincing for two principal reasons. The first is the prediction itself. Given the conceptual hurdles these forecasts must clear and the biases to which so many forecasters are subject, they are often plausible but seldom convincing. The second reason is deeper still. If we accept an investment strategy because we believe it offers a remedy for a bearish forecast, we are in effect saying that we think the manager can produce returns when the market does not. We credit the manager with the ability to create something from nothing.

Fighting the Market

When they use forecasts to encourage us to adopt their strategies, managers invite us to indulge in one of the great fallacies of investing – the belief that investing is a game of outguessing the markets. This is a view that misses the deepest truths about investing. Successful investing directly taps the fundamental source of return, the capitalist's share of the fruits of increase in productive enterprise. Productive enterprise requires planning. It involves assessing and assuming risks judiciously, and it demands patience. It has periods of frustration and moments of excitement, for at times returns are slow to come, while at other times generous gains arrive in a rush. Successful investing is similar: it requires us to be willing to *invest*—to assess risks and commit our capital thoughtfully. Yet, when managers imply (as I'll explain below) that some force is holding market values at levels that are too high, they are positing that the market will adjust to meet their estimation, contrary to the ongoing, organic risk assessments being done at every level of the market, the net value of which is reflected in the market itself. In a sense, they are saying they can outguess the entire market.

Predictions of Weak Returns

Forecasting a period of poor market performance amounts to saying that current market valuations are abnormally and unsustainably high. To see why, we appeal to two important academic concepts, Modern Portfolio Theory and the Efficient Markets Hypothesis. MPT has many parts, but one its central tenets is that investors only buy risky securities if they have an expectation that on average, the (uncertain) return they can hope for is higher than the return on, say, a Treasury bill.

So let's suppose an analyst predicts that the US stock market will have an annualized return of –2%, or –9.6% total, for the next five years. If we call today's value 100, the forecast implies a five-year target of 90.4. Yet MPT predicts that the market should be priced so that it's reasonable to hope for a return in excess of Treasuries. Academic analysts debate the size of this premium, but suppose this "normal" expectation is 7% per year. Over five years, that would be a return of +40%. But our bearish analyst predicts that five years from now, the market will be at 90.4, –9.6% below where it is today. If we accept 90.4 as the five-year target, and accept 7% per year as the normal market return, then the bearish forecast says, in essence, that fair

value for the market today is around 68.5. At 7%, an investment starting at 68.5 grows to 90.4 in five years.

Our bearish analyst's prediction amounts to a statement that today's efficient market price is something like –31.5% below the actual price. Let's examine this claim in light of the Efficient Markets Hypothesis. This concept describes an ideal world, in which market prices completely reflect the economic import of all publicly available information regarding securities and their issuers. Even those of us that grew up steeped in these theories generally admit that theoretical "efficient" values and observed, market prices do not always agree. The trouble is that we can't actually observe the theoretical values, so we can never know by how much they differ from market prices, or whether they differ at all.

Many of the more plausible arguments for weak returns do address the issue of valuation. An example is a *Barron's* feature profile of Rob Arnott of Research Affiliates. "Valuation levels, [Arnott] notes, are extremely high historically, and if you smooth out earnings over a 10-year period you see that price-earnings ratios are near what they were in 1929. 'That's alarming,' he says."[2] This type of historical comparison may be suggestive, but it fails in a crucial respect. The Efficient Markets Hypothesis is the baseline, and any deviation from it requires an explanation. Claiming that valuations are higher than usual does not defeat the EMH. If you want to claim that current market prices are somehow distorted, you must be able to explain how and why. The burden is on the analyst claiming that prices are wrong to identify the force that keeps the prices away from their efficient level. A plausible calculation of where the market should be is not enough. To be convincing, the analyst must also explain *why* the market is not trading at an efficient price. The analyst must identify the force that has created the discrepancy and allows it to persist.

Among the most serious attempts to explain how market prices may fail to be efficient are in the field of behavioral finance. The behavioral investigators describe a number of systematic cognitive errors that most people make, which they suggest could explain persistent mispricings in the markets. Behaviorists' lists of these errors often include a) overconfidence, b) "representativeness" – assuming that the recent past is representative of prospects for the near future, and c) "anchoring" – a phenomenon in which people's estimates for any quantity tend to cluster around its recent values.

Behaviorists run into a peculiar difficulty when they begin to offer investment forecasts. To claim that market prices deviate from the EMH, behaviorists must argue that cognitive errors are pervasive and powerful enough to drive a durable wedge between actual prices and efficient levels. At the same time, behaviorists making such forecasts must claim, at least implicitly, that they themselves are exempt from these pervasive, powerful errors. Consider this when you evaluate the confident predictions that the markets will do poorly for the next five years. In five years ending October 31, 2004, the S&P 500 has returned –2.2%, annualized. Whether through careful analysis or cognitive error, the analysts predicting poor future market performance are predicting

[2] Jack Willoughby, "Roving Rider," *Barron's,* May 17, 2004.

that the near future will be like the recent past. Any behavioral case for predicting low market returns suffers from at least the appearance that the prediction itself may be subject to the same cognitive biases.

It's important to state that I cannot make specific projections about the future direction or level of the markets. But absent a convincing demonstration of a force or mechanism holding market prices at inflated levels, I also can't accept as convincing the seemingly pervasive, yet unexplained predictions of inferior returns for the next several years.

Stock Pickers, Market Timers, and Hedge Funds

Let's suppose for the moment that our hypothetical analyst is right, and we are in fact in for a period of disappointing returns in the markets. Does it follow that stock pickers, market timers, and hedge funds can pick up the slack? If invested capital as a whole produces meager returns, then it is far from clear how any strategy can reliably generate strong ones. Managers relying on security selection hope for above average returns, but the average they beat will be low. If they miss, their (below average) results would be very poor. Market timers face the same difficulty, although across a broader array of asset classes. And managers seeking performance through arbitrage may have the worst problem of all. The greater the success with which they convince the investing public that investing is a poor proposition and arbitrage is better, the worse the strategy becomes. Exploiting an arbitrage tends to extinguish it, so as more money flows to arbitrage strategies, they become less effective.

Let's look at stock pickers first. One way to see the difficulty they would have rescuing a weak market is to think of a stock index return as the average return across some segment of the stock market. So it's essentially mathematically impossible for the average stock-picker to beat the market. It's why we smile when we hear that "all the children are above average."

Implicit in every stock picker's claim that you should look to them for performance, of course, is a claim that although the average stock picker must fail to add value, it's just a matter of picking the right stock picker. Guess who your average stock picker wants you to believe is the right one? Cognitive biases may be at work as well. After all, in presenting themselves as your clear choice, stock-picking managers may be suffering from a bit of overconfidence. And in presenting their recent performance (along with the mandatory disclaimer about past performance and future results), they may be inviting you to commit the "representativeness" and "anchoring" cognitive errors.

What about market timing? Even in relatively weak markets, the differences in short-term performance among asset classes would seem to offer ample scope for skillful maneuvering. It looks easy in hindsight, but how would a manager do it? Year to date through November 5, 2004, the S&P 500 has returned +6.37%. Year to date through October 22, 2004, the index had returned –0.13%. So the year's entire return

occurred in the two weeks from October 22 to November 5. It's difficult to imagine a market-timing discipline that would have shifted into US equities just in time for the most recent rally, which began a week before the election. The most reliable way to capture sudden upward moves in the market is to stay invested, and manage the risks.

Market timers, like stock pickers, are subject to the woes of anemic market returns. A weak market will not compensate for the inherent variability in the success of market timing. If the timer is wrong, a weak market affords less opportunity to make up the damage than a strong one. And if the timer misses a sharp move during a weak market, a second chance may be a long time coming. Market timing does not provide an escape from the realities of market returns.

Perhaps the most plausible of the proponents of alternatives to owning the market are the hedge funds. Their basic claim is that they provide attractive returns in all market conditions, by pursuing investment strategies that have low correlations to the market. As evidence they often cite the performance of recent years. For example in 2002, while the S&P 500 returned –22.1%, the CSFB/Tremont Hedge Fund Index (an averaging of returns across a large number of hedge funds of various types) returned +3.0%. In 2003, the S&P 500 returned +28.7%, and the CSFB/Tremont index returned +15.5%. So, the hedge fund managers claim, they played good defense in a down market, and had a good year in an up market. Let's look more closely.

For this note, let's take these hedge fund results at face value (there are various statistical problems with the hedge fund indices, but I'll skip those for now). While hedge fund managers claim their sources of returns aren't correlated with the stock market, they still need to extract returns from the investment universe as a whole, through security selection, timing, or arbitrage. The total amount of return available through security selection or timing still depends on the overall market return, so these strategies are subject to the same difficulties facing other stock pickers and market timers. Arbitrage perhaps has better prospects for providing returns unrelated to the stock market, but it has limits as well. As more traders pursue arbitrage strategies, the gains become slimmer. In addition, a perfectly hedged position should, in principle, produce a return similar to a Treasury bill, so hedge fund gains are related to some extent to interest rates. It is for perhaps these reasons that for 2004 through September 30 (the latest figures available), the CSFB/Tremont index has returned just +3.79%. Perhaps most telling of all, the publishers of hedge fund indices have lately begun to emphasize the relative performance of hedge funds against the equity market. Consider the following observation from another hedge fund index provider:

> "There's been quite a lot said about hedge funds' underperformance this year but, according to our Index, the average hedge fund has at least kept pace with stocks," noted George Van, Chairman of VAN. "The Van Global Hedge Fund Index has a preliminary year-to-date return through October of 3.1% net, the same as the S&P 500. The Dow Jones Europe Stoxx 50 is up 2.8% for the same period. It's also worth stating

> that the Van Index has shown somewhat less volatility this year than either of those equity benchmarks."[3]

This is faint praise for strategies whose promoters emphasize their ability to deliver strong returns in all market environments.

I don't mean to suggest that investors should avoid hedge fund strategies entirely. In fact, many investors can put hedge funds to use in well-structured portfolios. For many investors, certain types of hedge fund strategies may offer a risk profile that provides a useful complement or counterbalance for other systematic portfolio exposures. But as the results may indicate, a prediction of weak equity market returns does not automatically lead to the conclusion that investing in hedge funds will be better than investing in the productive engine of the real economy. The fallacy is in thinking of hedge funds as a substitute for exposure to the market.

Investing with discipline

Too often lost in the shuffle of trying to find today's best opportunity in the financial markets is a central truth in investing. The ultimate source of returns for investors is the real world economy, where businesses put their capital to use. Businesses can only attract capital on terms that compensate investors for their risk. Investors, in their turn, should adopt a level of aggressiveness that reflects the balance between risk and opportunity that suits them best. The public markets give investors a great deal of flexibility, both to diversify and to tailor portfolios that reflect their individual needs and preferences.

Consistent portfolio planning and design give investors their best prospect of realizing the benefits of providing capital to productive enterprise, while only taking those risks that offer a suitable probability of reward. The returns from a disciplined, consistent investment program can be quite variable. This variability may drive investors to seek alternative sources of return. But in the end, the only sure way to reduce variability is to adopt a more conservative portfolio, sacrificing upside.

Disciplined investors may make use of a variety of strategies, including ones that rely heavily on security selection, dynamic reallocation across sectors, styles, and asset classes, and, yes, hedge funds. But investors should use these techniques and investments in a judicious, thoughtful way, rather than as a substitute – even a temporary one – for a consistent, long-term investment plan. Each investment choice has its own profile of risks and opportunities. Investors should always be sure to take a unified view of all their investments, keeping their portfolios' design and structure consonant with their goals.

[3] "Van Global Hedge Fund Index Posts Preliminary October Gain of 0.4% Net; Year-to-Date Index Keeps Pace with S&P 500, Beats Europe Stoxx 50." BusinessWire, November 5, 2004.

Conclusion

Predicting the future direction of securities prices is one of the enduring conceits of the investment industry. Doing so is notoriously difficult. It requires that the individual analyst believe that his or her own assessment of a stock's or market's future prospects is more accurate than the one that emerges from the dialectical process of the market. Making matters worse for investors reading these forecasts, promoters of certain types of investment strategies sometimes offer predictions that are difficult to judge because they seem to argue for the promoter's own investment approach or product. Investors should evaluate these projections carefully, and judge whether they are sufficiently unbiased to support solid investment recommendations. Even then, investors should always evaluate all their investments in the context of a coherent plan designed to seek growth at a prudent level of risk.

- Jonathan Tiemann
Menlo Park

Source for returns data: S&P 500: Standard & Poors; some calculations by author. Hedge fund indices: Sources cited in quotations and footnotes.

Tiemann Investment Advisors, LLC is a Registered Investment Advisor based in Menlo Park, California. Dr. Jonathan Tiemann is President and Chief Investment Officer of TIA. For more information, please contact TIA at

750 Menlo Avenue, Suite 300
Menlo Park, CA 94025
650 566-0200
jonathan@tiemann.net

Copyright © Tiemann Investment Advisors, LLC 2004.