The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 7 - Issue 9

Behavioral finance

Luck and the illusion of stock-picking skill

By Stan Clark - Senior Investment Advisor

Let's face it: Our world is complicated and messy. Much of what happens is either entirely due to, or strongly affected by, luck.

With that in mind, I'd like to discuss luck and the illusion of stock-picking skill.

In his book *Thinking Fast and Slow*, Nobel Prize winner Dr. Daniel Kahneman points out that three powerful political leaders rose to power at almost the same time. Mao, Stalin and Hitler profoundly affected the world's political landscape for more than half of the 20th century.

At this point you're thinking, "What has luck to do with that?"

Well, consider that, at the time each leader was conceived, there was a 50-50 chance the fertilized egg would be a girl rather than a boy. You can be sure the world would be very different today if even one or two of those births had been girls.

The stock market, similarly, is complicated, messy and subject to the workings of luck. According to Kahneman, luck may be the dominant influence that decides how well a company, or a CEO or fund manager, performs year to year. But people don't want to believe luck is so pervasive. That gives rise to what Kahneman calls the "illusion of stock-picking skill."

Of investing, Kahneman says, "…a major industry appears to be built largely on an illusion of skill." Buyers and sellers trade billions of shares daily. They have roughly the same information about the stock they are trading but opposite opinions about what that information means for tomorrow's valuation of those stocks.

Kahneman cites an analysis of over 160,000 trades in 10,000 investor accounts. Stocks sold actually performed significantly better over the short term than stocks bought to replace them. The sold stocks, thought to be a poor bet for the future, outperformed the overall market by an average of 3.2%. In other words, sellers, often selling to lock in gains, ended up worse than the people who bought those shares. And, those who frequently traded fared worse than those who only sold occasionally, even after trading costs were factored out.

Whether it's individuals trading on their own accounts, or professional fund managers priding themselves on their training, experience and research, nearly all fail to win consistently. About two-thirds of mutual funds underperform the overall market in any given year.

Still, people cling to the illusion of skill, largely due to our two systems of thinking. System 1 finds cause and effect in the world. It builds stories to confirm that view: "Company A did well this year. Must be because it is led by a skilled CEO. Mutual Fund B outperformed the market; its manager must be a skilled stock-picker."

System 2 *could* analyze information deeply, but is innately lazy. System 2 would rather not work. It accepts System 1's illusions and any rationalizations needed to keep those illusions alive.

The illusion of skill is a deeply rooted, persistent cognitive illusion. In stock trading, it's hard to set aside because those who view themselves as skilled have a lot invested in that illusion. They review economic data, economic forecasts and balance sheets. They interview CEOs and try to evaluate how well companies are managed. They're not about to put their success down to luck.

Kahneman advises that, when you are evaluating a stock, the big question should be: "Is all the relevant information about a company already incorporated in its price?" He says most traders not only lack the skill to answer the big question; they are cognitively blind to that lack.

The illusion of skill is a trap, even for seasoned, professional investors. It leads them to have more confidence in their stock selections than they should have, considering how often their selections underperform the market. The only answer is to be aware of the role of luck, forget about relying on stock-picking skill, and develop an objective, unbiased approach to selecting stocks. Then, stick with that approach – no matter what others or your own intuitions tell you. ■

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