

The Sound Investor Series #60

What Were They Thinking?

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In the summer I sometimes read an article in a well-respected publication that makes me wonder if all the editors are on vacation.

In this week's edition of Business Week (August 7), there is a story "A Year of Beating the Indexes." Reading it I found myself saying "What were they thinking?"

The article's premise was to measure how well a Business Week columnist, Gene Marcial, picked stocks. Not a bad idea at first blush, but not a very good one in its execution.

Mr. Marcial's recommendations beat all the major indexes over various time periods ranging from one day up to 6 months. On the first day, his stock picks were up 2 percent while all the benchmarks were flat to slightly higher. Over 6 months, his portfolio rose 10.2 percent compared to benchmark increases ranging from 2.8 percent to 9.2 percent.

I assume the Finance column is intended to help readers make money, so one of the first things that should have jumped out to an editor was the stocks' first day performance of up being 2 percent. 120 of the 151 recommendations were up on the first day - when readers could not have been invested. This 2 percent increase represented 20 percent of the portfolio's 6 month gain. How did this help subscribers?

Investors need a chance to buy in order to reap the rewards of stock recommendations. Even if readers purchased the recommended stocks first thing on the Friday mornings after Thursday's night release, almost all price gains were already reflected in the Friday's opening price. For that reason, on Wall Street, the performance of analyst recommendations are measured from the closing price on the day or sometimes two days after the recommendation, not the previous day's close. Very possibly, Business Week is measuring its clout and distribution, not the stock picking skills of its writers.

Another issue with the article is its implicit encouragement of short-term trading. Why report only the performance up to 6 months? Professionals know that short-term trading is a losers' game for individual investors and should not to be encouraged. In other pages, the magazine often laments the short-term focus of investors and its effects on company managements. So why are investors being egged-on to think short-term here?

How did Mr. Marcial's recommendations do over the past year or two? This gets sticky to measure since Mr. Marcial does not tell readers when to sell a stock. BW says a lot can change in a year or two so "Investors need to keep a close tab on [the stocks]." One might ask why readers need Mr. Marcial's help in buying stocks, but not his help in knowing when to sell.

The article also touts his stock picking performance versus standard benchmarks such as the S&P 500, Dow Jones Industrial Average and Russell 2000. This illustrates the difficulty of benchmarking performance, not just for this article, but for all investors.

Business Week, with its expert staff, could have used sophisticated techniques to correctly benchmark their portfolio. One method is an attribution analysis which breaks down the performance of each stock into factors such as size (capitalization) and industry to measure why a portfolio performed as it did. Was Mr. Marcial's out-performance the result of choosing small cap stocks, the right industries or did he show real skill in stock-picking?

A related factor has to do with risk. What were the risk characteristics of this hypothetical portfolio? Beating the market by taking on more risk is not the same as beating it with the same or less risk. An analogy could be two people driving from point A to point B. Did the driver that got there first take a better route and show skill or did they just drive really fast and take a lot of risk of an accident or a ticket?

All investors should ask themselves these benchmarking questions when looking at their personal portfolios. Since the attribution analysis is beyond the scope of most investors, they should at least segment their portfolio by capitalization (large, medium and small) when comparing their performance to benchmarks. They should also look, at least generally, to see if they are not over-weighting, or ignoring particular industry groups and therefore taking on extra risk.

In summary, I once worked for Business Week's publisher, McGraw-Hill and think highly of the company. But, this article was not the serious journalism one expects from this respected publication. Maybe it should have been in a "special advertising" section rather than in the news section.

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