# *Can you really beat the securities markets?*

**Category : Investment Luck versus Investing Skill Articles**

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Can you really beat the securities markets? You are not likely to beat the stock market, despite all the cheerleading from the securities industry and the financial media. When you try to beat the public securities markets, unfortunately you are more likely to trail the market’s return, because of extra costs, taxes, and investment mistakes.The idea that investors can beat the market is extremely widespread. The financial media, the financial services industry, and the selective recall of people at cocktail parties around the world perpetuate this notion. Given how modern public markets price securities, how likely is anyone to beat-the-market consistently and what does it really mean to do so? (See: How investment securities are valued - snapshots in time and The confusing investment securities market motion picture) Consider that before costs and taxes, the average investor’s gross return will equal the market’s return. The market return will consist of all dividend payouts plus realized and unrealized capital gains or losses across all investors. The total return of a public securities market must equal the aggregated gross returns across all investors.1   Across all investors’ portfolios, there can be substantial variations in investment performance. Nevertheless, for every dollar of return in excess of the market return received by one investor, another investor will trail the market by a dollar. At the outset, therefore, markets are symmetrical with respect to the aggregate returns of winners and losers. For every dollar that “beats” the market, another gets “beaten by” the market. Moreover, this is before any costs or taxes are taken into consideration. However, costs and taxes can both have a very substantial negative impact on returns. (See *The Skilled Investor’s* various articles on investment costs and taxation. To begin, see: Excessive investment costs are a huge problem for individual investors) What would it really mean for you to beat the stock market? Because of fluctuations in the value of portfolios composed of different securities, an investor’s returns are just as likely to trail the market return as they are to exceed it at any point in time. If you beat-the-market for any period due to random fluctuations, this would hardly be the basis of any genuine pride about one’s investment prowess.  Instead, to truly beat the market should require the demonstrated ability: 1) to beat the market consistently over an extended time and 2) to do so against an appropriate risk-adjusted market benchmark that truly reflects the level of investment risk of the investor’s portfolio. If one is able to do this, then at least there is a possibility that the results could be due to skill rather than dumb luck.  The scientific investment literature points strongly to luck rather than skill as the explanation for the investment performance of individuals and professionals whose returns exceed the average. For example, the lesson from the scientific finance literature is that a mutual fund manager’s apparently superior past performance does absolutely nothing to help predict future mutual fund performance. The fine print in every mutual fund prospectus carries the real truth, when it says, “don’t count on past performance.” Instead, it probably should be the largest typeface with bold flashing red letters. (See: Do Morningstar Ratings predict future risk-adjusted equity mutual fund performance?) While superior past investment fund performance says nothing about the future, very inferior mutual fund performance does serve as a positive predictor of continuing inferior mutual fund performance in the future. The first likely explanation for the perpetuation of inferior past performance is that inferior performing funds are more likely to have higher expense charges. Higher fees drag down mutual fund performance and become a self-fulfilling prophesy. Second, it is possible for fund managers not to be very competent and this can drag down performance. Conversely, however, competent money managers have a lot of competition from other competent mutual fund managers, which helps to bring about efficient market pricing and put a huge damper on the potential for earning superior returns consistently. (See: How stable have Morningstar Ratings for mutual funds been over time?) The scientific investment literature also indicates that past and current stock prices contain very little information to predict future prices. While securities price movements are not entirely a “random walk,” they are awfully close to it. There seems to be a very slight persistence in the price movement trends, but this is not something that individual investors have any reasonable chance of detecting. Furthermore, it is not likely they can execute an effective portfolio management strategy to capitalize upon this slight price trend persistence. The vast majority of individual investors just do not have the capital, knowledge, time, data, computational power, and trading capabilities to compete effectively with professional money managers and traders.  These observations reinforce the validity of efficient markets theory. If current market prices tend to reflect fully known information and to be adjusted for anticipated risk, then one should expect no more or less than a risk-adjusted market return before investment costs and taxes.  From the perspective of the individual investor seeking to beat-the-market, the following factors should be considered ->At best, there is a 50:50 chance of beating the market before investment costs and taxes. Costs and taxes dramatically lower your odds.   ->Presumably, beating the market should require superior skills, better knowledge, and greater predictive abilities. Luck should be hard to sustain over a long time. (See: Distinguishing between true investment skill and luck)  ->Superior skills, better ability to interpret information, and greater predictive abilities presumably require money and/or time to develop. Higher personal costs and greater time commitments, presumably have an opportunity cost. These increased costs would require you to beat the market by an even higher margin. This lowers your odds of beating the market further. (See: The value and opportunity cost of your time) ->Evidence from the scientific investment literature indicates that the average individual investor is a very poor portfolio manager. Individual investors suffer from litany of behavioral biases that drag down their performance and cause them to under-perform market return benchmarks. Conversely, the average active professional manager is much better at investment management. However, he charges much more than his services are worth, that is on average his fees are higher than his increased performance. Because the markets are symmetrical with respect to winners and losers, it is likely that professionals actually perform better at the expense of amateurs. Nevertheless, either through inferior personal performance or through the excessive costs of active professional managers, the individual investor is more likely to trail a passive, risk-adjusted market return.  In summary, the 50:50 chance to beat-the-market that an individual investor would seem to have with respect to gross returns can be dramatically reduced by investment costs and taxes, by the opportunity cost of their time commitment, and/or by their investment mistakes.  The prognosis for individual investors beating the stock market is simply not good. The financial media feeds the beat the market illusion, because it sells their products. The financial services industry feeds the illusion, because it eases the securities sales process and generates fees and commissions from individual investors who chase performance and churn their portfolios.  Beating the market is just an appealing illusion, which is more often built upon ego than evidence. If you are persuaded by the information in *The Skilled Investor*, then you may be better able to hold to the strength of your investment convictions. When you are at cocktail parties, you may more confidently ignore or politely suffer the securities market braggart.  Stock market conversations at cocktail parties about personal investment prowess are likely to be highly selective and exaggerated. Perhaps, vocal stock market victors at cocktail parties have replaced the dwindling supply of anglers in our society. Fishermen are not to be believed, and everyone knows that they need to be humored. It is the same way with such amateur conquerors of the securities markets.  The standards of truth are often rather lax in cocktail party conversations. One positive aspect to the not too distant stock market crash is that there has been far less boasting in the past few years and much more commiseration. In private recollections it is not so easy to forget investment “failures”. When your savings and investments are supposed to put your kids through college, allow you to retire comfortably, and enable you to pass on an inheritance or make substantial charitable gifts, then the balances of your asset accounts will tell the real story. Unfortunately, the resurgence of the stock market combined with selective memories means that this learning will be short-lived for many.

See these related articles on investment luck versus skill: ->Chance creates the illusion that investors can beat the stock market ->The illusion of superior professional investment manager performance

1) Sharpe, William F., “The Arithmetic of Active Management.” Financial Analysts Journal, January-February 1991, p 7-9