Distinguishing between true investment skill and luck

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Distinguishing between true investment skill and luckEven if an investor has obtained superior results over an extended period, is this sufficient proof that these investment results were actually due to skill? No, these investment results could still be due to chance. For example, take a large population, such as all individual investors in the U.S., and have each person perform a random chance operation like flipping a coin repeatedly. After many repetitions, a small portion of the population could appear to have remarkable results. After 10 consecutive coin flips, some investors probably would have flipped 10 heads in a row (HHHHHHHHHH). If each head were to indicate a consecutive win in the stock market, that person might seem like an investment genius. However, ten heads in a row is no more or less likely than any other particular sequence of heads and tails. The person who flipped THTTHTTHHH has a sequence that is just as unique as 10 heads in a row. The person who flipped THTTHHTHHH, which is different only on the sixth coin toss, also has an equally unique sequence. However, to many people, these sequences of heads and tails would not appear to be nearly as exceptional as 10 heads in a row, even though the really are. Repeated investment success may still be the result of luck rather than skill.While it may appear that the person who got 10 heads in a row did something remarkable, it just appears to be more unusual, because the results were all the same. In a similar vein, if a large population of investors were each to choose investment securities at random and were to do this repeatedly, the results will be purely accidental. However, those who happened to pick securities with better results might seem like geniuses.   Given human propensities, you could almost guarantee that the longer the sequence of their accidental winners, the more the chests of these lucky winners would inflate with pride. They would probably also become increasingly vocal. The fact that they are no more or less likely to be a winner in the next round than any other participant, might be lost on them and anyone who hears their story, until the results of the next round are known. In addition, even if they lose the next round, they may conveniently not report their loss. Too many lucky throws of the investment dice and these persons could be absolutely insufferable at cocktail parties. (See: Can you really beat the securities markets? and Chance creates the illusion that investors can beat the stock market)   Only if an investor makes numerous specific predictions over time about WHY the prices of various securities will move in particular directions and those predictions come true far more often than not, can investment skill rather than dumb luck be demonstrated.Because long-term success may still be due to random chance, there needs to be more stringent criteria for judging true investment skill. True skill might be demonstrated by two methods: ->An investor with superior skill could have a better understanding of what known information means and could use trading strategies to capitalize upon that better understanding. For example, such an investor might be better at using published accounting information to identify companies whose default risks would in fact turn out to be different from what others judge them to be. If such an investor made a large majority of such accurate selections, then it would be more probable that this analyst demonstrated superior skill.   ->An investor with superior skill might be a better prognosticator of what is likely to happen in the future. In this case, the investor would make specific prior predictions about things that would happen. A higher degree of accuracy on specific predictions would be a way to identify an investor with skill.   Both of these potential sources of verifiable skill have a common element, which is the specificity of their predictions. Not only must an investor with skill call the direction of price movements, he must also predict why the price will move with a reasonably high degree of factual precision. If an investor predicts that a security will perform exceptionally well for specific reasons, and it does perform well, but for reasons that have nothing to do with his predictions, then this is still a chance result and not skill. (See: [The illusion of superior professional investment manager performance]) The future unfolds unpredictably, and just because it turns out one way or another does not make an individual investor a genius or a fool. An investor can only properly claim to be an investment genius when the proof is indisputable over a very long history of precise predictions of what would happen. Moreover, as with soothsayers and charlatans, it does not count to predict accurately a few times in the midst of a very large number of inaccurate predictions. Certain investors have received substantial acclaim because they once accurately called and acted upon a turn in the market, while their other erroneous predictions were forgotten. Note also that an investor is not necessarily a fool if the future happens to unfold differently than he predicted. His assessment of opportunities and risks may have been reasonable at the time he made his judgment. However, what he may have been concerned about might not have materialized because other factors became more dominant. An investor is only a fool, if he convinces himself that he can predict the future, when he does not have a specific record of accomplishment as evidence. Investors who have been lucky and become over confident because of their past luck can become very dangerous to their own future financial welfare.