

Stock Picking: Skill versus Luck?

NZ Broker Picks

For the past five years the NZ Herald has polled a number of New Zealand broking firms for their top five share picks for the year ahead and has then viewed the results one year later against the NZSX 50 gross index.

The 2007 results are consistent with earlier years of the study – some brokers will exceed the market index and some will fall well short. However, the ranking of best to worst broking firms alter somewhat randomly over the 5-year study period confirming that forecasting stock returns is a perilous activity reliant more on luck than skill. See table below

Broker Picks 2007 – Results

Broker	Total Return	Comparative Ranking		
		2007	2006	2005
Direct Broking	15.5%	1	5	8
ABN Amro Craigs	13.6%	2	n/a	3
First NZ Capital	2.3%	3	1	1
Forsyth Barr	1.3%	4	8	9
NZSX 50 Gross Index	0.4%			
McDouall Stuart	-0.9%	5	7	4
ABN Amro	-3.6%	6	4	5
Goldman Sachs JB Were	-7.2%	7	6	7
Hamilton Hindin Greene	-10.2%	8	2	n/a
ASB Securities	-12.9%	9	3	2
UBS		n/a	n/a	6

Being on the wrong end of this luck equation can be costly. The total NZSX 50 gross return more than doubled over the 5 year period, with five firms achieving higher returns with their aggregate top five share picks and six firms posting results substantially less than the NZSX 50.

One natural criticism of surveys such as the one above is that the brokers identified just five shares and it assumes the holding was constant from the beginning to the end of the year. This question leads us directly to the assessment of the performance of active money managers. Surely a manager that is actively trading by selling out of underperforming shares and buying new attractive opportunities as they are identified throughout the year will do better. One might assume that the closer they monitor the market, and their professional skill should give them an advantage over the aggregate of all the market pundits combined.

A second potential criticism would be that it's not fair to judge performance on such a short timeframe of just one year? After all, aren't shares a long term proposition? The measure of skill versus luck would surely be evident by the consistency of delivering an over-performance compared to the market as a whole over consecutive years.

Fortunately there are numerous impartial studies that provide a sound basis for answering both of these questions. In essence they illuminate the fact that the results of active managers are somewhat arbitrarily spread around the average performance of the index itself. One recent study utilising Morningstar data on 316 funds in the Australian market, and published by Morningstar, statistically examined the consistency with which funds added value against an index over five and seven year periods to 30 June 2003. They publish three key lessons from their analysis:

Lesson # 1: One good result does not equate to skill

While any number of funds can beat a benchmark over a period of time, few can demonstrate that they have done this with any degree of skill.

Lesson # 2: Fees do matter

Quite simply, a fund that charges higher fees will find it more difficult to add value against a benchmark compared with a cheaper fund.

Lesson # 3: Different asset classes deliver different excess returns



The study confirmed that the greater the levels of risk in an asset class the greater the opportunity for excess returns within that asset class. This highlights the dangers of drawing conclusions from simple return figures. A return figure tells you where the fund finished – it doesn't tell you how the race was won.

The findings of this study, and the anecdotal performance of local brokers last year as outlined in the NZ Herald study, provide yet more verification for adopting a well diversified investment strategy in constructing client portfolios. If we needed any further reinforcement of this concept we need look no further than studies which compare fund manager performance with the chance generated by simple coin flipping: as you might expect some exceed the average and some fall short. Further, those managers that do well in one year don't tend to repeat – past performance is not predictive of future performance.

It is the growth in the market itself, rather than skill of individual managers that delivers investment returns. Our task is to harness that growth in broadly diversified segments appropriate to each client's objectives and risk tolerance, and manage tax and costs to efficiently deliver market returns to each client.