



Tashkent State University of Economics

Household finance

Lecture 11: Frequency and profitability of trading.

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Individual Investors

- ▶ Series of studies by Brad Barber and Terrance Odean
 - ▶ *Even before costs, stocks bought underperform and stocks sold go on to outperform.*¹
 - ▶ The more investors traded, the worse the results. Those that trade the most underperform on a risk-adjusted basis by 10 percent p.a.²
 - ▶ Investment clubs underperformed by over 4 percent p.a. on a risk-adjusted basis.³
- ▶ Mensa club underperformed market by almost 13 percent p.a. for 15 years⁴

Behavioral Finance

- ▶ Behavioral finance is the study of human behavior and how it leads to investment errors.
 - ▶ Overconfidence – Confuse familiarity with safety
 - ▶ Subject to herding – Loss aversion
- ▶ Behavioral errors can lead to the mispricing of assets.
 - ▶ Pricing anomalies are inconsistent with the Efficient Market Hypothesis (EMH).
- ▶ However, the question for investors is not whether the market persistently makes pricing errors.
- ▶ The real question is: Are the anomalies exploitable?



“Behavioral Finance: Are the Disciples Profiting From the Doctrine?”

- ▶ Behavioral funds are successfully attracting investment dollars at a significantly greater rate than index and matched actively managed nonbehavioral funds.
- ▶ Investors believe that the pricing errors are exploitable.
- ▶ While the behavioral funds do outperform S&P 500 Index funds, they do so because they have significant exposure to value stocks.
 - ▶ After adjusting for risk, they do not earn abnormal returns.
- ▶ Conclusion: “Behavioral mutual funds are tantamount to value investing.”



Behavioral Finance

“He [Richard Thaler] concedes that most of his retirement assets are held in index funds. ... He also concedes that ‘it is not easy to beat the market, and most people don't.’”

— Jon E. Hilsenrath



“Behavioral Finance: Are the Disciples Profiting From the Doctrine?”

“I have personally tried to invest money, my client’s and my own, in every single anomaly and predictive result that academics have dreamed up. And I have yet to make a nickel on any of these supposed market inefficiencies. An inefficiency ought to be an exploitable opportunity. If there’s nothing investors can exploit in a systematic way, time in and time out, then it’s very hard to say that information is not being properly incorporated into stock prices. Real money investment strategies don’t produce the results that academic papers say they should.”

— Richard Roll, financial economist




Why Is Persistent Outperformance So Hard to Find?

- ▶ It is easy to identify the managers with great *track records*. However, there is no evidence of the ability to do this *ex-ante*.
- ▶ The EMH explains why this outcome is expected — only by random luck should a fund persistently outperform.

AND

- ▶ Even if markets are inefficient, successful active management sows the seeds of its own destruction.



Who Gets the Money to Manage?

- ▶ Money flows to the top-performing manager.¹
- ▶ Eventually, the manager receives so much money it impacts the ability to generate alpha and returns will be driven down to the second best manager's expected return.²
- ▶ The process continues until the expected return of investing with any manager is the benchmark expected return.³
- ▶ Inflows eliminate return persistence because fund managers face diminishing returns to scale.



“Scale Effects in Mutual Fund Performance:

The Role of Trading Costs”

- ▶ Covered 1,706 U.S. equity funds for the period of 1995-2005
- ▶ Trading costs, on average, are greater than the expense ratio
 - ▶ Variation in returns is related to fund trade size
 - ▶ Trading costs are negatively related to performance
 - ▶ Negative impact increases as a fund's relative trade size increases
 - ▶ \$1 in trading costs *decreases* assets by \$0.80 for large relative trade size funds



“Scale Effects in Mutual Fund Performance: The Role of Trading Costs”

“Our evidence directly establishes scale effects in trading as a source of diminishing returns to scale from active management.”






Successful Active Management Sows the Seeds of Its Own Destruction

- ▶ As fund assets increase, either trading costs will rise or the fund will have to diversify across more securities to limit trading costs.
- ▶ The more a fund diversifies, the more it looks like its benchmark — becoming a *closet index* fund with higher costs.
- ▶ The higher costs are spread across a smaller amount of differentiated holdings, increasing the hurdle of outperformance.



How Markets Really Work

- ▶ The EMH explains why investors cannot use publicly available information to beat the market.
 - ▶ All investors have access to that information. Therefore, it is already embedded in security prices.
 - ▶ The same is true when it comes to selecting active managers.
 - ▶ Investors should not expect to outperform the market by using publicly available information to select active managers.
 - ▶ Excess returns should go to the manager — in the form of higher fees.



Which Is the Scarce Resource?

The Ability to Generate Alpha
OR
Investor Capital



How Markets Really Work

- ▶ “When capital is supplied competitively by investors but ability is scarce only participants with the skill in short supply can earn economic rents.”
- ▶ “Investors who choose to invest with active managers cannot expect to receive positive excess returns on a risk-adjusted basis.”
- ▶ “If they did, there would be an excess supply of capital to those managers.”

— Jonathan Berk



Why Is Persistent Outperformance So Hard to Find?

The underlying basis for equity forecasts is economic forecasts. Do they have value?

- ▶ William Sherden, author of *The Fortune Sellers*, reviewed the leading research on forecasting accuracy from 1979 to 1995 and covering forecasts made from 1970 to 1995.¹




William Sherden: The Value of Economic Forecasts

- “Economists cannot predict the turning points in the economy.”
- “There are no economic forecasters who consistently lead the pack in forecasting accuracy.”
- “There are no economic ideologies that produce consistently superior economic forecasts.”
- “Increased sophistication provides no improvement in economic forecast accuracy.”
- “Consensus forecasts offer little improvement.”



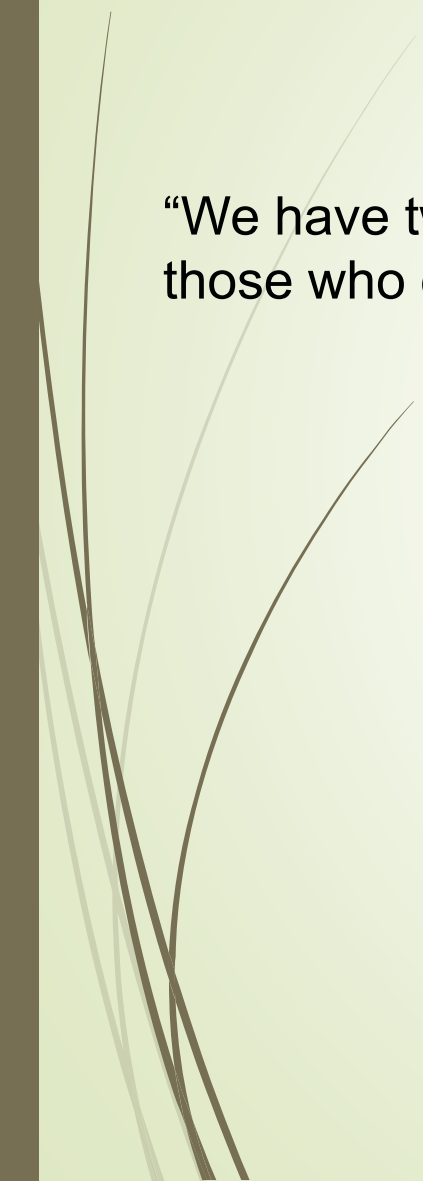
William Sherden Concluded

- “Despite recent innovations in information technology and decades of academic research, successful stock market prediction has remained an elusive goal.”
 - “Overall, we have not made progress in predicting the stock market, but this has not stopped the investment business from continuing the quest, and making \$100 billion annually doing so.”
- 



John Kenneth Galbraith

“We have two classes of forecasters: those who don’t know — and those who don’t know they don’t know.”





Michael Evans

“The problem with macro [economic] forecasting is that no one can do it.”





Benjamin Graham

“If I have noticed anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what’s going to happen to the stock market.”

