



## Stock-Pickers Rejoice: Markets Aren't Efficient, Investors Aren't Rational

### Description

Proponents of passive-indexing approaches to investing often cite academic research that purports to show that most actively managed equity investment funds fail to beat the indexes by which they're benchmarked.

Dr. Thomas Howard used to believe that orthodoxy too, until he started to apply his academic research on behavioural portfolio management (at the University of Denver) to actually investing in the real world. To his eventual astonishment, he found his stock-picking process actually did beat indexing. He built on the pioneering Nobel-prize-winning research of Dr. Daniel Kahneman, author of the book, [\*Thinking Fast and Slow\*](#). The company Dr. Howard founded to exploit these anomalies is called Athenainvest Inc., based in Greenwood Village, Colorado. (see [www.athenainvest.com](http://www.athenainvest.com)).

I heard Dr. Howard speak in Ottawa this month at T. E. Wealth's annual wealth conference (at which I was also speaking on the subject of financial advice for millennials.) The T.E. Wealth advisors listening were free to incorporate Athenainvest into their clients' portfolios or not, but the talk certainly made an impact on attendees.

Dr. Howard began by stating the well-known proposition that emotions are the most important determinant of wealth creation. "Compared to emotion, the rest of portfolio management is insignificant."

Building superior portfolios is straightforward but emotionally very difficult to achieve, he said. Markets are NOT efficient, and individual investors are NOT rational, he declared—a statement that flies in the face of the oft-accepted efficient market hypothesis so beloved of many finance academics.

"Prices are always wrong. It's just a matter of degree. People make cognitive errors all the time." This creates behavioural price distortions. Those "price distortions are the norm which active management can take advantage of." Markets are dominated by emotions, which account for both overconfident buying of stocks and panicked selling.

But in the long run, the odds are overwhelmingly in favour of the stock investor: markets are up 55% of trading days, 65% of trading months, and 75% of trading years, he said. As a result, he believes a

100% stocks portfolio is a “slam dunk case” for investors of any age (and especially young people.)

Even at his own advanced age of 68, Dr. Howard says he still has a personal time horizon of 50 years, and thus he’s still 100% in stocks. “I’ve never bought a bond. I want to be wealthy.” He then encouraged the advisors in the crowd to declare, “It’s okay to be wealthy!”

So building superior stock portfolios is as simple as setting an asset allocation of 100% stocks and then never touching your holdings. “It’s as simple as it gets.” But, of course, this turns out to be very difficult to do emotionally. Investors need to tell themselves that they don’t need “short-term emotional comfort.” But while investors may kid themselves that bonds are safe and comfortable investments, they’re not. “The riskiest asset class by far is T-bills and Bonds are not far behind ... Bonds are incredibly dangerous.”

Howard showed a slide of investment returns for the last 30 years to demonstrate the long-term cost of emotional investors seeking comfort from risk. The S&P500 index trounced fixed income, but actively managed equity funds did better still: the firm’s website states that “truly” active management can deliver excess returns of 5- 6% a year.

And concentrated “high-conviction” portfolios or “Best Ideas” funds limited to 10 holdings do even better. Best of all were strategies that selected certain geographic markets or economic sectors via exchange-traded funds, or ETFs, and that were amplified with leverage. “Debt is good most of the time, especially at these (low) interest rates.”

A similar chart can be found [here](#) at his website. It shows average annual returns of all 20-year periods between 1951 and 2015 were 5.5% for cash, 7.2% for bonds, and 10.8% for stocks.

During a subsequent Q&A, I asked Dr. Thomas what he thought of DFA Funds (Dimensional Fund Advisors), which, like Athenainvest, had its origins in academic finance. I know many excellent financial advisors who put clients into DFA index mutual funds. Dr. Howard replied that Athenainvest is “like DFA, but goes far beyond.” Despite the image of DFA being index funds, they are really actively managed, he said, since their portfolios are consistently constructed to “tilt” towards small-cap and value factors.

Athenainvest subadvises portfolios for advisors and institutions with three main specialized equity portfolios: Athena Pure Valuation/Profitability, a concentrated long-term-growth portfolio launched in 2002; plus two launched in 2010: Athena Dividend Income Equity and Athena Global Tactical ETFs. In 2011 it also launched Athena Managed Equity, which blends the three specialized portfolios.

The takeaway for Motley Fool investors? If Dr. Thomas is correct, then individual stock-pickers may be on the right track. If nothing else, a surf through the Athenainvest website should provide a counterargument to the loud proponents of passive-indexing approaches.

## CATEGORY

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