Are Stocks a "Random Walk?"

Description

After recently reading Burton Malkiel's *Random Walk Down Wall Street*, it made me wonder just how easy it would be to beat the market by randomly picking stocks and selecting a small sample to test the hypothesis.

To keep my experiment unbiased, I'd look at the one-, two-, and three-year returns of five randomly picked stocks that currently have market caps between $100 million and $1 billion.

If I were to look at stocks that have been around five or 10 years, that could skew the data, since a stock would have to achieve even some success to still be around after such a period of time. Similarly, successful stocks would typically have large market caps, so I wanted to eliminate that bias as well.

First, let's take a look at how the TSX has done. In the past 12 months, the market has risen 9%, while over two years it is up 13% and up 17% in the past three years.

Below are the five randomly selected stocks I selected and a summary of their performances:

Stock	1-Year Return	2-Year Return	3-Year Return
BSM Technologies Inc. (TSX:GPS)	-10%	**+23%**	**+36%**
Transat AT Inc. (TSX:TRZ)	**+39%**	**+29%**	**+25%**
Sprott Inc. (TSX:SII)	**+37%**	**+24%**	**+47%**
Pulse Seismic Inc. (TSX:PSD)	+4%	+10%	+6%

High Liner Foods Inc. (TSX:HLF)	-42%	-48%	-56%
Total Portfolio Return	**5.6%**	**7.6%**	**11.6%**

A quick look at the above results shows us that the TSX would have outperformed this random mix of stocks. Although, without High Liner's disappointing results, the averages would have been much different: 17.5% this past year, 21.5% over two years, and 28.5% over three.

It's easy to see how one bad pick, or one good one, could have an adverse impact on overall returns when selecting a basket of stocks. These stocks also offer some diversification, as none of the above are in the same industry, and yet that still wasn't enough to even match the market's returns.

Now, obviously, these picks were completely random, and if I were to pick another five random ones, the results could be even more different. What's interesting is that the extreme returns were largely negated, and the overall portfolio wasn't too high or too low.

The three high-performing stocks (Transat, BSM, and Sprott) were able to offset the poor performance of High Liner, but Pulse's mediocre performance was not enough to generate a strong overall return for the portfolio.

If we added more stocks to this list, we would have seen more of an average return, as the highs would have negated the lows, and we'd see a return more in line with the market as a whole.

The problem with investing is that even though you might have four good picks, one really bad one could bring down your portfolio, and diversifying it away can be difficult to do.

Except for the most recent year's results, three of the five stocks did outperform the TSX.

What can we take away from this?

What I see from this experiment is that the more stocks that you pick, the less it matters on the individual holding, whereas if you only pick one stock, it's a roll of the dice how you do. If you have to pick one stock, you're better off going with an ETF.

I'm not sold on the random walk, as the one stock that was down in my random portfolio was down each year, while the top ones were consistently at or near the top in each of the three years.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:HLF (High Liner Foods Incorporated)
2. TSX:PSD (Pulse Seismic Inc.)
3. TSX:SII (Sprott Inc.)

PARTNER-FEEDS

1. Msn
2. Newscred
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