3 Tips (and 1 Stock) for You to Improve Your Odds of Beating the Market Over the Long-term

Description

Many pundits believe that markets are efficient and that it's not possible to achieve alpha (excess risk-adjusted returns) on a consistent basis. For investors who buy into this hypothesis, passive investment instruments like index funds and ETFs are the way to go. They keep your fees low and will grant you the greatest returns over the course of the long-term.

Many buy into the concept of market efficiency, but there are also others who believe that alpha is consistently attainable through various techniques, most notably fundamental and technical analysis.

Moreover, there's empirical evidence out there which suggest that the efficient market hypothesis is severely flawed.

While the state of market efficiency remains up for debate, one thing is certain: investors are human, and humans are emotional creatures who may not always act rationally, especially under high pressure circumstances.

In reality, the market is neither efficient nor inefficient. These terms overly simplify what the market's actual state. It's somewhere in between, and depending on your view, it could be leaning towards either efficiency or inefficiency.

I think that market efficiency fluctuates depending on the state of the environment. And while there are a tonne of variables any instance in time, I believe the most influential variable is the aggregate psychology of investors.

It's not just about the year-ahead expectation for returns; it's about the "herding" mentality of investors, whether through the rapid inflation of a cryptocurrency bubble or the sharp selling everything at a loss when the markets crash.

It's these temporary instances of severe market inefficiency when investors should be exhibiting a contrarian mindset to profit profoundly off the irrationality of others.

Here are three ways to increase your odds of beating the market over the long term:

Add emerging market exposure into your portfolio

Make sure you've got some international exposure to your portfolio. I know that sounds glib, but it's true, especially if you want to increase your chances of beating the market. Empirical evidence shows that emerging markets are less efficient than their developed counterparts.

That means that the opportunity to obtain alpha from fundamental analysis is substantially higher with a stock in an emerging market than with a domestic stock that everybody on CNBC is talking about *ad naseum*

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But investing in developing markets can be risky, especially if you know nothing about what businesses exist in the first place. This is true, especially if you're a part-time investor who can't stay up to date, but the solution to this issue is simple: **Fairfax India Holdings** (TSX:FIH.U) is your one-stop-shop for market-beating emerging market exposure.

You've got a brilliant investor in Prem Watsa and his team looking for the biggest value/growth opportunities within the hot Indian market which, over the long term, will probably put developing market returns to shame!

Stop being afraid of small-cap stocks

For securities with low liquidity, it's harder for Mr. Market to be efficient. So, there's typically an opportunity to get a dollar for a dime.

Now, that doesn't mean you should buy penny stocks; they're poison! The sweet spot lies in securities with market caps that are well north of the $100 million mark.

Moreover, it's a lot more likely you'll grab a multi-bagger with a small name than a behemoth of a telecom like **BCE**, a name that a majority of mutual funds already have a piece of.

Profit from the overreaction of others

The average investor is loss averse and will tend to overreact to negative situations and follow the herd out of a collapsing stock. In such cases, there is a temporary inefficiency in either a specific security or the markets as a whole. In these situations, when the sky is falling, is when you should act.

As Warren Buffett says: "Be greedy when others are fearful." With a long-term mindset, buying on a big dip is typically a great way to achieve alpha as you take advantage of the emotion-driven anomalies.

Foolish takeaway

As you may have guessed, Fairfax India fits the bill for all three traits: it's a small-cap, emerging market play and right now, it's oversold with shares down 21% from all-time highs. Mr. Market is selling this stock at a considerable discount to its intrinsic value, so I'd urge investors to load up today.

Stay hungry. Stay Foolish.

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