

# Go steady — stock-picking is investment taken to extremes

**W**e all recall the stocks we should have bought but didn't — Apple, Paddy Power, Google. My could'a, should'a, would'a portfolio is crammed with stocks that experienced an exceptional rise over the past few years. Alas, I was a mere by-stander.

Several years ago, I had an epiphany: stock-picking is a skilful game and should be reserved for those with the time to devote to it. I didn't have the time — not to mention the skill. Today, bar one individual stock, all of my investments are through diversified funds.

What I didn't appreciate at the time was just how difficult stock-picking is, even for the professionals. Buying is only half the battle. The rest is deciding when to sell. I bought Anglo Irish Bank in 1998 before selling in 2001 to fund the purchase of an engagement ring. I endured the pain of that trade as it continued to rise several-fold for the next eight years.

A fascinating new report from JP Morgan sheds some light on the difficulties of stock-picking. It's sober reading, even for investment professionals. Consider this:

■ Since 1980, two-thirds of US stocks have underperformed the Russell 3000 index. Yes, that's a one-in-three chance of picking a stock that outperforms the index.

■ The median stock returned 54% less than the index.

If you were investing over the last generation you might be forgiven for believing it

## GARY CONNOLLY COMMENT



would have been difficult not to do well. The US stock market has risen 20-fold since 1980, yet the JP Morgan report shows that 40% of stocks have suffered large and permanent declines — defined as a drop of 70% or more that was not recovered.

The reason the overall market did well is because of a handful of winners — 7% of stocks are extreme winners, driving the index. The odds of picking such stocks in advance are tiny.

I have long been of the view that there is a place for active



management in a portfolio. Capital markets efficiently price assets, but this is not to say that efficient prices exist as a condition of capital markets. It is true that the majority of active managers fail to beat their benchmarks consistently. However, one of the main reasons for this is the lack of incentive to outperform.

Managers are paid a percentage fee that grows in line with the fund. At a certain size, it makes more sense to hold on to existing business than risk redemptions if performance falls off for a period. "Active"

managers end up engineering portfolios to look like the benchmark and give themselves little chance of adding value.

As such, I would have a preference for fund managers that are genuinely active — there are a few ways of assessing this — and I have also been favourable towards more concentrated portfolios when using active managers.

I read the JP Morgan report with some discomfort, therefore, as it makes clear that, over the long run, some companies substantially outperform the broad market, but the odds are stacked against the average concentrated holder. Of course that is not to say active managers cannot participate in the strong performance of stocks and avoid subsequent under-performance. And some active managers I like run concentrated portfolios that have delivered exceptional returns.

But it does copper-fasten my view that passive instruments should form a reasonable portion of the average investor's portfolio. Indeed, Warren Buffett's advice for the cash that will be left to his wife is that 90% should be invested in a very low-cost S&P 500 index fund. I wouldn't be quite as bullish on passive but, if you are going to go it alone, I'd suggest 90% index funds and 10% Buffett — until you find out you're no Buffett. Then heed the advice of John Bogle, founder of Vanguard, and buy the haystack not the needle.

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Paddy Power stocks experienced an exceptional rise, but many don't