

Recipe for success doesn't include any specific ingredient

Tim Harford, columnist with the Financial Times, tells an interesting story about the US air force. In 1943, the American statistician Abraham Wald was asked to advise the air force about how to reinforce its planes.

Early in the war, British commanders began to examine planes that had returned to base after being shot during bombing missions. The thinking was the patterns and location of the bullet holes would provide valuable information about how to protect them better in future. The proposal was to reinforce the wings, the centre of the fuselage and the tail because these areas sustained the most damage.

Wald concluded the British were going about it wrongly. Wouldn't it be better to examine those planes that didn't make it back? When planes were hit in the wings, tail or central fuselage, they made it home. Wald suggested reinforcing the planes in other areas.

It's natural to look at life's winners; but there may be more to learn from life's failures. What is it about success we find so fascinating? When I think about success in my field, I'm naturally drawn towards thinking of investing legends such as Warren Buffett, Seth Klarman and Prem Watsa.

Investors are on a constant search to explain why one strategy outperforms another. Something within us wants to focus on success

GARY CONNOLLY COMMENT



as a pattern for more success and we attempt desperately to explain it. Enabled by a vast industry of economists, investment managers and quantitative wunderkinds, there are hundreds of studies purporting to explain why one strategy does best.

As investors, if we rely on evidence from the winning strategies, like the US air force, we may end up investing our money in the wrong place. A recent paper by three American academics – Campbell Harvey, Heqing Zhu and Yan Liu – concluded that the findings of the majority of papers in financial economics are mistaken. This has significant implications for investors.

The report was inspired by a 2005 study that shook the medical community when it proclaimed that more than half of all medical findings are false. Harvey, Zhu and Liu set out to find if the same was true in the area of finance.

They studied 315 papers that examine different factors that might predict stock market returns. The papers propose all sorts of potential predictive factors, which at face value appear plausible.

In attempting to figure out

what exactly is correlated with high stock market returns, academics and finance gurus often compare many different variables.

The issue here is what Tim Harford refers to as the “jelly bean problem”, named after a cartoon. The cartoon shows scientists testing whether jelly beans cause acne, applying a commonly used test. The test assumes jelly beans don't cause acne but, if the observed correlation between jelly beans and acne has less than a 5% probability of occurring by chance, this assumption is suspended.

The scientists test 20 different colours of jelly beans and “amazingly” green jelly beans are correlated with acne! If you're studying lots and lots of variables, you have a greater chance of a false result.

If 20 statistical patterns are analysed, and there's no genuine causal relationship in any of them, we'd still expect one to look correlated. Correlation is not causation.

Green jelly beans no more cause acne than umbrellas cause rain, but both are correlated with each other.

This has implications for the advertisements we are

shown for financial products and investment strategies. One only has to look at the market for guaranteed investment products in Ireland. It is replete with strategies dreamt up by quant geniuses. If the number crunchers are not careful (or lack integrity), the analysis will produce plenty of freaks. And the freaks often appear plausible and marketable.

The performance of some of these products is scarcely credible. But too-good-to-be-true products have an essential crutch: naïveté on the part of the investor.

Those who do not invest tend to overestimate what actual investors can accomplish, much of it informed from the bar stool.

The Warren Buffetts of this world may propagate the notion that those “in the know” can deliver outsized returns. This is true of Buffett, but he is an exception. Investing successfully is not easy. Nor should it be. It demands more than analysing what has worked in the past, however erudite that analysis may appear. As Buffett says: “If past history was all there was to the game, the richest people would be librarians.”

We can't help being drawn to success and what has worked. But if it appears too good to be true, trust your gut. Which usually says that it is.

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