gateway financial marketing

GATEWAY INSIGHTS

8 Anomalies

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The general wisdom around investing is that stock markets are efficient. Investors are rational and are seeking to maximize returns. Of course, however, we see many instances of irrational behaviour. There are seasonal patterns, there are valuation discrepancies, and there are market bubbles such as the dotcom bubble, when companies with barely any profits or sales had billion dollar valuations.

A recent article in The Economist (Feb 23rd ,pg 78) reported the latest quirk to be examined by academics, momentum, or the tendency for stocks that did well in the past to do well in the future. Three academics at London Business School apparently devised portfolios consisting of stocks that outperformed over a 12 month period. They waited a month to buy them and then rebalanced the portfolio after a further month. In the British market, the "winners" under this methodology outdid the worst performers by more than ten percentage points a year over 108 years! Why would such a glaring anomaly not be arbitraged away?

The Economist suggests that market prices are tough to beat because of the "wisdom of crowds" phenomenon. If people are asked to estimate the number of jellybeans in a jar, their average estimate is usually close to the truth; indeed the average guess is far better than the vast majority of individual guesses. But this wisdom depends on the diversity of the people making the guesses. Problems occur when diversity breaks down and "groupthink" starts to take over. Investors no longer guess how many jelly beans are in the jar, but what other people's guesses might turn out to be.

Perhaps the key for fund managers looking to identify market anomalies or new market trends is to encourage diversity of thinking amongst their team.

At the recent van Eyk Conference, attended by Gateway, we saw an interview with John Trudgian from Williams Inference (www.williamsinference.com), a business intelligence service that looks for anomalies and makes inferences on subsequent events as a result of those anomalies.

The Williams Inference suggests that the key to searching successfully for anomalies are inferential scanning, synthesis and reporting. As an example, they found a newspaper article about 18 months ago which spoke of a growing trend for people to be living out of the back of their cars. When they investigated this trend, they found that these people were having their homes repossessed, and it gave them a heads up on the then looming credit crisis.

As a fund manager you require both science and art to be successful. The talent of inferential scanning is perhaps one of the most important parts of the 'art' piece. What are the inferences you can make from a limited data set, what are the patterns of change? The key here is to infer "unintended messages" through spotting anomalies or trend-spotting.

In summary, investors are not as rational as we would like to believe, which is why investors can get lured in to buying stocks in the hope that they are the next big thing. Exploiting these anomalies can assist the fund manager outperform. Team diversity and detailed analysis of trends may just help the fund manager come up with the right amount of jellybeans!

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