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Cherry Tree Wealth Management

CHERRY TREE WEALTH INSIGHTS: Published by Eric Annett, Investment Advisor at Cherry Tree Wealth Management, LLC, with insights on investing and wealth management.

THE CASE AGAINST STOCK PICKING

A central theme of our investment strategy at Cherry Tree Wealth that we repeat often in conversations with our clients, is that we don't like to invest in individual stocks. But why is that? We believe there are enough reasons that a book could be written about it. In this newsletter our aim is to explore some of the biggest reasons why we believe stock picking is a losing game that we prefer to avoid.

Issue 1: The Odds Are Not In Your Favor

"Stocks only go up" is a phrase you've probably heard if you have paid any attention to the meme stock frenzy of the early 2020s or Reddit forums like WallStreetBets. Now, we all know this was meant mostly as a joke and not an actual ethos for any serious investors. But do you know to what extent this is untrue? The actual numbers are eye opening.

Out of over 29,000 stocks studied, 69% of them failed to keep up with the overall market. More than half lost money, about a third lost more than 75% of their value, and another third essentially matched the market return.

Hank Bessembinder, a professor at Arizona State University, found in his research spanning every publicly traded stock on the NYSE and the Nasdaq from 1926 to 2019 that most individual stocks underperform one-month Treasury bills over their lifetime. Even though the average buy-and-hold stock return was over 30,000%, the median return was -6.9%. This is because outperformance was concentrated in an extremely small number of winners, and most stocks are losers.

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In those 90 years the US stock market created $34 trillion of wealth for investors. Almost half of that was created by just 86 stocks. The entire $34 trillion can be attributed to just the thousand top-performing stocks, which is just under 3.5% of the entire market. Do you want to bet your retirement savings on your ability to find a needle in a haystack?

Issue 2: The Math Is Not In Your Favor Either

In addition to the low probability of picking a winner, the proposition of stock picking is also a math problem. This is thanks to compounding. Compounding interest has been famously called the 8th wonder of the world. Because of the ability to earn interest on interest, those investments with compound returns are able to grow exponentially over time.

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But the power of compounding cuts both ways. Losses compound too, and that accelerates losses. The deeper your investment loses value, the amount you need to regain to break even increases exponentially too. You need to earn 11% to break even on a 10% loss, but a 50% loss requires a gain of 100% and a 90% loss requires a 900% gain just to get back to where you started. This isn't a statement on the stock market, but just the reality of the math. When combined with our understanding of how much more likely you are to pick the stock that loses 90% than the one that gains 900%, it is easy to see why most investors do better in broadly diversified, index-based funds.

Issue 3: The Paradox of Skill

Wall Street strategist and Columbia Business School professor Michael Mauboussin describes another issue we face in the stock market: the paradox of skill. Simply put, there are thousands of brilliant people who went to elite universities, attained rigorous professional credentials, and now work in the financial industry who are all trying to earn superior returns. Even they have a hard time doing so, research from S&P Global found 86% of professional fund managers fail to outperform their benchmark over 10 year periods. The paradox is that as more people become better at an activity, the difference between the best and worst, and the best and average shrinks. Thus, the more highly skilled market participants there are, the more you actually need luck to achieve outcomes that used to be attributed to superior skill.

Issue 4: The Timing Problem

The final issue we'll cover in this letter is market timing. Even if you get lucky enough to pick a winning stock, it's still not that simple. The issue with market timing is that it requires you to be right twice: first when you buy a stock, and then again when you sell it. Getting these moves wrong can cost you dearly, and even if you hold a stock that's been a winner, your holding period can lead to wildly different results. You've probably heard plenty of stories of people kicking themselves for selling a stock right before it shot up, or buying at what proved to be the top. Winning in the markets requires a blend of high skill, tremendous luck, and unshakeable discipline. It is no wonder that very few people have been able to do it with consistency!

This does not mean we are pessimistic about the stock market as a whole, nor do we avoid stocks in client portfolios at all costs. We are optimistic about the long-term potential of the markets and even recognize that there are times and places where buying or holding onto individual stocks can make sense. But for most people we work with, it is wiser to buy the haystack instead of looking for the needle. That means sticking to diversified, low cost index-based ETFs rather than trying to pick winners in the stock market. Owning the entire market through funds ensures you will always have the biggest winners.

Cherry Tree Wealth Management, LLC (CTW) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Eric Annett has over 10 years of experience in a variety of roles in the Wealth Management industry, which have included portfolio management, trading, investment research, and financial planning. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Visit our website at http://www.cherrytreewealth.com.

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