Opinion **Equities**

Myths can make 'smart money' act dumb

Assumptions about valuations and economic indicators have more power than they should

MILES JOHNSON

Investment professionals are having to contend with a new breed of online day trader © Brendan McDermid/Reuters

Miles Johnson JUNE 11 2020

Those who earn a living analysing financial markets are enduring testing times. Many money managers have been left baffled as stocks have rallied to near all-time highs at a time of a global pandemic, civil unrest and mass unemployment during an awful recession.

Not only have these exasperated professionals lost money, but they must also now contend with a new breed of online day trader who has revelled in relentlessly mocking their misfortune.

Dave Portnoy, an internet celebrity, has posted daily trolling videos about his profits from the rally to his 1.5m Twitter followers. "The people on the internet are debating who is the better investor right now, myself or Warren Buffett?", he said in a post this week. "It's no debate. I killed him. He's dead."

Even worse for the investment industry is that the rally has once again seen managers paid to add value lose out to passive investment funds. The "smart money" — for now at least — has taken a beating, while those who many disparagingly like to refer to as "dumb money" are howling with laughter.

All this is bewildering for many who pride themselves on understanding financial markets. For some, it is cause to mutter darkly about the day when a sudden reversal in fortune will immolate the portfolios of day traders like Mr Portnoy, wiping the grin from his bearded face.

In all probability, the day traders will discover before not too long that random, frequently leveraged speculation based on stuff posted on Reddit sooner or later ends in tears. But many professional investors should also pause and think hard about many of their own enduring, unchallenged and frequently unfounded assumptions about how markets work.

Basing investment decisions on such beliefs is not likely to yield much better results than randomly punting on penny stocks, yet many persist on treating them as if they were carved in stone.

The most common is the widely held notion that what happens to the economy, be it global or national, will predictably be reflected in stock prices. This assumption underpins much commentary, and a huge amount of collective effort is devoted to forecasting gross domestic product on the understanding that this is valuable to investors.

Currently, many analysts have been stunned that stocks could be close to their all-time highs during such a sharp recession. But there is scant long-term evidence to suggest that the near-universally accepted concept that economic growth is correlated with stock market performance is true.

New York University finance professor Aswath Damodaran recently wrote: "the notion that stock markets and economies are closely tied together is deeply held, simply because it appeals to intuition". However, US data going back to 1960 shows, "there is almost no correlation between stock returns and real GDP growth . . . In short, there is almost nothing of use to investors from poring over current macroeconomic data, which is one reason why markets have started ignoring them."

Yet not a day goes by when analysts pore over some economic variable in an effort to forecast GDP, which is then assumed somehow strongly and predictably to correlate with how markets perform.

Valuation is another concept mangled by many who consider themselves sage professionals. The market, they will say, is “expensive” or “cheap” based on the aggregate ratio of share prices to the combined earnings of companies in an index. It is still standard fare for markets commentators to say “the S&P 500 trades at a multiple of X, therefore it is expensive”. Those who have continued to invest using rudimentary notions of “statistical value”, buying stocks or indices with low headline p/e ratios, have underperformed for a decade.

This an abuse of the concept of valuation because an aggregate ratio detaches valuations from the underlying businesses they reflect. The question should never be what valuation does a company trade at, but at what valuation does a company deserve to trade?

Answering that question is certainly not easy. But many top-down market commentators fail to understand that, in the simplest terms, some companies are far better than others. There are many other factors beyond valuation to consider, such as a company’s vulnerability to competition, its capital intensity and growth prospects

Mr Buffett, the butt of Mr Portnoy’s jibes, once wisely said: “When ‘dumb’ money acknowledges its limitations, it ceases to be dumb”. By the same stroke, smart money that fails to question the myths that it clings to can no longer be considered that smart.

miles.johnson@ft.com

Copyright The Financial Times Limited 2020. All rights reserved.