Invest Sensibly | Volume 1

Capricorn Asset Management
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Can you beat the market?

A key feature of investment management is that the majority of investors wish to beat the market. This is true for individual investors, businesses and institutional investors. This thinking is part of the natural psychology of humankind, which is hardwired in our DNA, that only the fittest, or winners, survive. However, this core programming is, in fact, the biggest enemy and destroyer of value in the investment environment. Few investors realise that they are their own worst enemy.

To be effective in wealth creation and, specifically, to be a successful investor, the first step is to understand that the drive to outperform the average is in most cases, unrealistic. What is more important is to remove your emotions and DNA programming and to approach investment without adhering to your natural inclinations and emotions. This is very hard or even impossible for most to do. However, if you can achieve this paradigm shift, you will be wealthy in the long term. In this article, we wish to demonstrate this principle with specific reference to the listed equity (shares) market. Other aspects of sensible investing will be dealt with in future articles.

Coming back to the question of whether you can beat the market, the short answer is yes, but to do so consistently is very difficult and rare. To convey this point, one must consider the hypothesis that to beat the market, one must either have superior information to act on or rely on luck. I think we can agree that luck may work in the short term but that it is not sustainable. Winning through luck is like going to a casino. It simply is not viable due to the law of large numbers. It's like flipping a coin. You may get lucky if the trend is in your favour to win the toss repeatedly, but it will not last. The other source of outperformance is superior information. The problem with superior information, on the other hand, is that historically information was scarce and took long to reach all market participants, and when it did, it was not at the same time. The internet changed this forever, and anyone with an internet connection can access information on any listed company in the world in virtually real-time. In fact, regulatory requirements aimed against insider trading have forced the disclosure of any company information to the whole market. The net effect of this has been that superior information is generally no longer available on listed companies. So, the playing field has been levelled between all investors and especially between professional investment firms. As a result, beating the market has become very hard to do in highly liquid and information-rich markets such as listed equities.

So, stemming from above and following the reasoning, we need to look at the cold hard facts. The only quality data available is that of the formal investment management industry. Consider the fact that for the 5 years up to 30 June 2019, 78% of active fund managers in the USA and 90% of fund managers in South Africa have not managed to beat the listed equity market performance. Furthermore, the data shows that regarding their ability to beat the market consistently, which is also defined as their persistency rating, there was not one equity fund in the USA that have managed to repeat their top quartile performance of the previous 5 years in the successive 5 year period and indeed a large percentage of top-performing funds move down to the lowest quartile performance in the successive period. (Source Spiva, SP Dow Jones Indices https://us.spindices.com/spiva/#/reports).

The conclusion is that in many cases it is better to invest in a low-cost index fund to achieve the average market return virtually guaranteed than to believe that anyone has the ability to pick the winning manager over the next 5 years and to achieve better returns than the market. It is sensible to rather place half your funds in a cheap core index fund and have the assurance of achieving the market performance versus running the risk of the incorrect picking of shares yourself or an active manager. However, many investors will never believe that they have to expect the average and that it will actually be a good result. They will always be willing to make active bets directly or through their manager. A sensible approach is to put half your money in a low-cost tax-efficient index fund and make active bets with the other 50%. Over time compare your actual growth with the 100% certainty of achieving the market return. It is a worldwide trend which has not yet taken off in our part of the world but is sure to explode in popularity going forward.

"…while enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street, it almost invariably leads to disaster." Benjamin Graham, The Intelligent Investor.

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