"Alles Andere isch Wurst"

Noise & Fiction

Most financial news is either interesting but irrelevant to investment portfolio management or relevant but not actionable. And, where it is both relevant and actionable, its veracity is likely to be in doubt.

Epistemology, the study of knowledge, says there are two conditions for something to be true: Correspondence and Consistency. Correspondence means a statement corresponds to reality (using science-based methods of testing), and consistency means the statement is consistently true when tested over time and cross-sectionally.

Many of the core foundations of investing do not adequately meet one or both criteria. Below are 'facts' that may surprise you:

- "Deflation is bad as consumers defer purchases resulting in lower national demand and economic growth". There is, however, both limited and mixed evidence of this. The example of Japan has shown that declining economic growth has led to deflation and not the other way around.
- "To fight price inflation, central banks need to raise interest rates," is a core mantra of nearly every investor and economist. But don't forget raising interest rates has two countervailing effects: It lowers demand for goods and services (dampening prices) but also increases the costs of goods and services (as the cost of borrowing of companies producing those goods and services rises). The former does not always win over the latter, particularly if demand was not excessive in the first instance and inflation was supply-driven.
- The belief in the safety of many "safe-haven" assets has been repeatedly eroded. For example, former adages such as 'safe as houses' or 'you can bank on it' are no longer used today. Gold, also widely believed to be a safe-haven asset recently, has proven itself otherwise in recent months. Similarly, the behaviour of the US Dollar and, to a lesser extent, US Treasuries have not conformed to their safe-haven status in many periods.
- "Buy consumer staples stocks as they are defensive in market downturns." Over several market corrections, however, consumer discretionary stocks have behaved defensively, not the staples.
- "Rising prices reduce demand" is a basic tenet of economics. Well, when it comes to stock prices this is not the case. Research has consistently shown that rising stock prices lead to greater demand, which in turn leads to further price increases.
- "We raise our allocation to equities on the expectation of strong economic growth." In reality, and likely to the surprise of many, the correlation between stock markets and economic growth is modest at best (even with a lagged dependent variable) with studies showing that economic growth accounts for only c.5% of stock market returns.

Irrationality & Interpretation

Adding to the plethora of noise and unverified 'facts' is the fallibility in investors' absorption of these facts. Behavioural finance research suggests investors are "boundedly rational". That is, investors are subject to faulty emotion-influenced decision-making. The prolongation of bull-markets over the decades would even suggest an accentuation of irrationality over time.

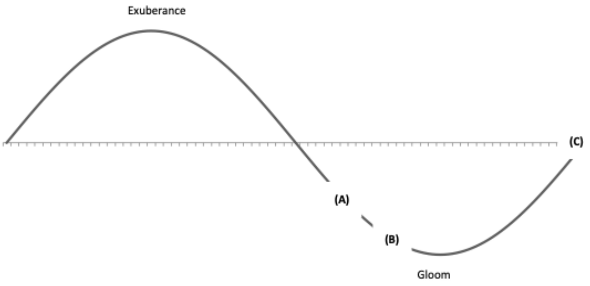
Finally, even when we assume some investors are perfectly rational, their approaches to profiting from irrational markets diverge. This could be illustrated by the investment approaches of Warren Buffett and John Maynard Keynes.

Mr Buffett (a good investor but poor economist) would suggest buying stocks when they are significantly undervalued, holding for as long as necessary, and selling only when they reach fair value (investor rationality attained again).

Mr Keynes (admittedly, a poor investor but good economist) would suggest otherwise, however. He would suggest selling in periods of bust and fear as fear itself would lead to a vicious cycle of further selling and further fear in the near to medium-term.

Referring to the chart below, Mr Buffett would be happy buying at point A with a view to selling at point C, while Mr Keynes would be happy selling at point A with a view to buying at point B.

Chart 1: Diverging Behaviour of Rational Investors



Summary

There is a great plethora of 'interesting but irrelevant' or 'relevant but inactionable' financial news. And, where news is both relevant and actionable, its veracity (or at least the veracity of the assumptions underlying its interpretation) is questionable. In addition, we have faulty, emotionally-driven investor decision-making. Finally, further compounding the muddiness of financial market behaviour are the diverging investment implications of relatively rational investors.

Opinion

Whether you are a Buffett-style (value-driven) investor or a Keynesian-style (momentum-with-growth) investor, the core of stock selection decisions should be based on (a cross-sectional comparison of) readily available stock price (and volume) data and audited corporate financial accounts. As the Swiss would say, 'Alles andere isch Wurst' - all else is hardly relevant.

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