Reflections Of A Registered Subversive

by Bill Matson

I've always been suspicious of "conventional wisdom". Too often it seems to be created by "experts" more notable for their smooth talk and political savvy than for the merit of their ideas. Even when contradicted by mountains of empirical data, their constructs not only maintain their status with the general public, but also within academia and other enclaves populated by those who should know better.

My guess is that TNS members are somewhat better than average at distinguishing truth from spurious conventional wisdom, especially within the realm of their professions. But whereas I can spot scams a mile away on Wall Street, I know there are a multitude of arenas in which I am deceived and ripped off quite regularly. It occurs to me that if all of us having conventional wisdom to refute within our fields of expertise started sharing what we know in *Vidya*, this might be useful to many readers — as well as potentially beneficial to the businesses of those who contribute their insights.

A couple years ago, I wrote a piece for *Vidya* that challenged TNS to become something of a Chamber of Commerce for its members. This notion seemed to float off into the ether, and I pretty much forgot about it myself. Then Thorsten resurrected it in his maiden editorial and asked me to write a *Vidya* article about my own business.

I cringe within when asked for stock tips at cocktail parties. Though the person asking the question may well be interested in what I have to say, others within earshot are likely to become annoyed if they perceive my response as an attempt to inappropriately commercialize a social occasion.

There are important differences, though, between the interactions we expect at social gatherings and what we hope to encounter through our participation in TNS. While I'm certainly courting peril with this generalization, I am comfortable likening TNS to a hotel with many conference rooms. Some of these rooms are for discussions of the Higgs boson, medieval literature, and other blatantly non-commercial topics. Others are reserved for networkers, job hunters, salespeople, and hyper-enthusiastic entrepreneurs.

I will now open a new room in which TNS members skewer the specious conventional wisdom in their respective professions. And I will christen it by taking on the Wall Street establishment, as well as several thousand finance professors

and a squad of Nobel Prize-winning economists.

Efficient Market Theory (EMT) holds that nobody can consistently beat the market because all publicly available information is instantaneously incorporated into stock prices. EMT was the springboard for the careers of several Nobel laureates and is the intellectual foundation of the multi-trillion dollar index fund industry. It became popular among academics because the simplifying assumption of an efficient market made it possible to apply a wide variety of mathematical tools to the construction of portfolios, as well as to the measurement and control of risk.

True believers in EMT don't need to read corporate financial statements or press releases. So long as they stay well diversified, they don't really need to know much at all about the companies they own, nor need they care how much they pay for their stocks. Somehow, in its infinite wisdom, the market will see to it that everything they buy or sell is properly priced.

Mitch Hardy and I co-authored a 500+ page book entitled *Data Driven Investing* that thoroughly refutes EMT. Published in 2004, it is largely based on the tens of millions of data points in S&P's Compustat data base, a multi-decade compilation of financial statement figures and daily stock price movements covering thousands of companies.

In seeking to identify patterns within this data predictive of abnormally high (and low) returns, what Mitch and I found, among many other things, was that:

a) small company stocks, on average, had consistently provided much higher returns than large company stocks, and

b) companies whose market capitalizations[1] were low multiples of company sales, earnings, and book value[1] significantly outperformed their high multiple counterparts. In other words, value outperformed growth[2].

Following a strategy of buying equal amounts of the 100 smallest companies with market caps over $10 million (in 2002 dollars) and reconstructing the portfolio every year on 12/31 would have resulted in a 441,700% return between January 1951 and December 2002 (assuming zero commissions). This figure also assumes that one could actually have executed one's buys and sells every year at the December 31 closing price. OK, this is an admittedly unrealistic number.

[1] Market capitalization (or market cap) = Number of shares outstanding x Stock price

[1] Book value = Assets - Liabilities

[2] Low multiple stocks are commonly referred to as "value stocks", while those with high multiples are considered "growth stocks"

©2010 by Bill Matson

But consider the returns obtainable, given the same assumptions, by investing in similar fashion in inflation-adjusted market caps just over $100 million (129,200%), $250 million (66,600%), and $1 billion (30,200%) — or in the 100 largest market cap companies (14,700%). Despite decades of underperformance by corporate behemoths, the conventional wisdom has been that small companies are speculations and that serious money belongs in GM and AT&T. Though this assertion is somewhat inconsistent with EMT, an equally mainstream piece of conventional wisdom, I construe it as 100% consistent with my conjecture that each is dead wrong.

The disparities in returns between similarly constructed and annually rebalanced portfolios of value and growth stocks are even more breathtaking. The 100 companies having the lowest Market Cap/Book Value ratios would have returned 4,887,700% between 1951 and 2002 (a compounded annual return of 23.1%). Those with the highest ratios would have yielded a compounded annual return of just 2.5%.

I also applied our findings in managing my own money — in a test portfolio whose results were documented through inclusion of my brokerage statements in our book's Appendix. Between July 2000 and March 2004, it enjoyed returns of 788%, with total gains of over $3 million. (As you know, however, past performance does not guarantee future performance.)

The most frequent criticism of *Data Driven Investing* is that we failed to adequately assess the statistical validity of our conclusions. My position is that using Gaussian measures (i.e. standard deviations, Sharp ratios, and the bell curve) to describe financial market phenomena is absurdly inappropriate. Once again, I find myself at a variance with conventional wisdom.

Any assertion that the bell curve is capable of explaining or predicting financial market activity is impossible to defend in view of such events as:

- the German Papiermark's slide from 4.2 to 4.2 trillion per USD between 1914 and 1923,
- the 23% decline of the S&P500 on 10/19/87, which equates to approximately a 25 standard deviation phenomenon (based on historical daily price volatility figures) — on a Wall Street ruled by the bell curve, such a move could be expected roughly once in every 10^{134} years (i.e. once every hundred trillion trillion trillion trillion trillion trillion trillion trillion trillion trillion trillion years), and, more recently,

- the “flash crash” and “flash recovery” of 5/6/10, when the Dow lost roughly 7% in 15 minutes and gained nearly all of it back within the following hour.

There is a silver lining on the cloud of denial in which believers in a Gaussian Wall Street envelop themselves. Some securities have huge payoffs when the unthinkable occurs, and those who underestimate the odds of the unthinkable occurring tend to sell such securities too cheaply to those who have a more realistic world view.

Many investors lack the time and resources to implement the strategies in our book, so we started an investment management firm to do it for them. Cognition Capital Management, LLC (CCM) is a registered investment advisor, and our forte is the management of value stock portfolios with a small company focus for accounts of $2,000 to $1,000,000 (or more). Information about our firm, including our track record since 2005, is available at www.cognitioncapital.com.

CCM actively supports investor rights, including the extension of fiduciary standards to all financial advisors. Fiduciary responsibility can be summed up as a duty to put client interests first. Whereas registered investment advisors, such as CCM, have this obligation, stockbrokers and insurance agents generally do not — though they typically lead their clients to believe otherwise.

The conventional wisdom among lawmakers, apparently, is that investors know enough to avoid being ripped off by their advisors. To dramatize our opposition to policies allowing stockbrokers employed by government-controlled institutions to sidestep fiduciary responsibility, we became the first investment firm to register with the state of South Carolina as a subversive organization.

I hope that other TNS members with a subversive bent will share their conventional wisdom-puncturing insights in future!

©2010 by Bill Matson